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CIS

MONOPOLIZATION AND COMPETITION IN THE TELECOMMUNICATIONS INDUSTRY

HEARINGS

BEFORE THE

COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

FIRST SESSION

ON

MONOPOLIZATION AND COMPETITION IN THE
TELECOMMUNICATIONS INDUSTRY

JUNE 10, 17, JULY 23, 24, AND 29, 1981

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MONOPOLIZATION AND COMPETITION IN THE TELECOMMUNICATIONS INDUSTRY

WEDNESDAY, JUNE 10, 1981

U.S. SENATE,
COMMITTEE ON THE JUDICIARY,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2228, Dirksen Senate Office Building, Senator Arlen Specter (acting chairman of the committee) presiding.

Present: Senators Thurmond, Mathias, Grassley, and Specter.

Staff present: Peter Chumbris, chief counsel for antitrust, and Bruce Cohen, counsel to Senator Specter.

OPENING STATEMENT OF SENATOR ARLEN SPECTER

Senator SPECTER [acting chairman]. Good morning.

We will convene this hearing on Senate bill 1159.

The telecommunications industry plays an important role in the efficient operation of the U.S. economy. As we continue to become increasingly dependent on the prompt and accurate transmission of information, the efficient allocation of resources to and within the telecommunications industry will have an ever-greater impact both on the domestic and international levels.

For this reason, it is important that Government address issues of monopolization and competition in this industry, to make certain that all is being done to facilitate healthy and vigorous competition.

The hearing this morning will focus on competition in the domestic and international record carrier industry. We will be examining the present structure of the industry, its competitive history, and its prospects for the future. In this context we will be considering legislation that is pending in the Senate, insofar as it impacts the relative competitive positions of the telecommunications firms in this industry. Also, we will attend to the possibility of future legislation germane to antitrust issues in telecommunications.

Although unable to be with us this morning, Mr. Mark Fowler, Chairman of the FCC, has submitted a letter referencing the FCC's testimony on S. 271 and S. 898, and indicating his willingness to respond to questions on issues that may develop during the course of this hearing. I am also informed that the Justice Department, Antitrust Division, will be submitting a written statement which will be entered into the record when it is received.

The first witness will be Mr. Alan Pearce.

Will you step forward, Mr. Pearce?

STATEMENT OF ALAN PEARCE, TELECOMMUNICATIONS ECONOMIST

Mr. PEARCE. Good morning. My name is Alan Pearce. I am an independent telecommunications policy consultant.

Senator SPECTER. Have you submitted a statement, Mr. Pearce?

Mr. PEARCE. No; I am sorry.

Senator SPECTER. Would you summarize the testimony you would like to present?

Mr. PEARCE. Yes; I teach courses in regulatory economics and industry structure at George Washington University and international business at the University of Maryland in the Graduate School of Business Management.

I have a Ph. D. in international business, economics and telecommunications from Indiana University, but, as you can tell from my accent, I am not a hoosier. I am originally from the United Kingdom of Great Britain, and Northern Ireland, which, sadly, is neither great nor united anymore.

I have no client interest in this area. My role today is to attempt to explain the industry structure in the area of international telecommunications.

Senator SPECTER. Mr. Pearce, you are listed on our witness schedule as a telecommunications economist. Would you outline briefly your educational background and your other qualifications which make you an expert as a telecommunications economist?

Mr. PEARCE. I have a Ph. D. in international business, telecommunications, and economics from Indiana University. I studied as both an undergraduate and a graduate student at the London School of Economics and Political Science, University of London. I worked as a special assistant to Chairman Dean Burch of the Federal Communications Commission and also to Chairman Richard Wylie when he was Chairman of the FCC. I worked for 2½ years on Capitol Hill, in the House of Representatives, for the Subcommittee on Communications, and I also worked in the Executive Office of the President as a telecommunications policy adviser.

Senator SPECTER. All right. May we now have the benefit of your expert opinion?

Mr. PEARCE. Thank you very much.

Policymaking in international telecommunications is much more difficult and more complicated than it is in domestic telecommunications. The reasons for this are obvious: Facilities planning issues affect the sovereign rights of the many nations of the world, thus making total international accord and system optimization an impossible dream. Consequently, the many political, govermental, technological, and economic problems are seldom resolved to anyone's satisfaction.

The nations of the world, understandably, have widely differing needs and policy goals in this area. Most countries are not heavily involved in the transoceanic routes and facilities that are used predominantly by the Unied States, Canada, and a few Western European countries. As a result, they are not overly concerned with service rates and service costs as a method to determine the optimal mix of cables and satellites.

Some nations of the world—and in particular those in Western Europe—have a greater stake in cable manufacture than they do in satellite technology, while most nations have no particular stake in either.

In many countries of the world, the revenues derived from international telecommunications are used to cross-subsidize chronic operating deficits in domestic telecommunications and postal services. These revenue considerations tend to result in higher international rates.

Additionally, many of the world's emerging nations are becoming increasingly interested in satellites as a means of providing an efficient and low cost modern international domestic telecommunications system.

So far as industry structure is concerned, international telecommunications services in the United States have traditionally been handled by a government regulated cartel—a cartel dominated and controlled by A.T. & T.

The Federal Communications Commission has allowed A.T. & T. to exclusively handle all telephone, or voice, traffic to all foreign points. Other companies, known as record carriers—which is old-fashioned regulatory parlance for telegraph or so-called nonvoice traffic—include RCA Globcom; I.T. & T. Worldcom; Western Union International, a subsidiary of Xerox; TRT Telecommunications, a subsidiary of United Brands; French Telegraph; and U.S. Liberia Radio.

RCA, I.T. & T., and Western Union International are the big three record carriers with international revenue shares of 36 percent, 34 percent, and 22 percent respectively—a total of 92 percent.

Senator SPECTER. What is the basis for your statistics on market share?

Mr. PEARCE. I have researched this as a professor at George Washington University, using data obtained from Federal Communications Commission files.

Senator SPECTER. The FCC has made the determination that that is the market share?

Mr. PEARCE. And other sources. When I worked up here on Capitol Hill I researched this issue then, so I have been researching the issue of international telecommunications traffic patterns on the Hill.

Senator SPECTER. My question to you is how do you get this information? What data gives you an evidentiary basis for the conclusion you just articulated?

Mr. PEARCE. FCC sources primarily, which I could submit to you.

Senator SPECTER. Does the FCC directly state that is the market share, as you have just represented?

Mr. PEARCE. Yes.

Senator SPECTER. We would like to have the source of that information. I note you are reading from a prepared text, which, as you say, you have not submitted. It would be very useful to us if you would submit the text as well.

Mr. PEARCE. Thank you very much. I shall do that.

The other three carriers are insignificant, with French Cable, for example, having only a 1 percent share of total overseas record services revenues.

In revenues, A.T. & T. grosses over $1 billion while the IRC's gross $400 million-plus among them annually.

Among the other international players in the provision of international telecommunications facilities is Comsat, the Communications Satellite Corp. Comsat is an independent, publicly owned company, established by the Congress in 1962 to represent the United States in what became Intelsat, the 105-country International Satellite Consortium that manages today's global communications satellite system.

Under section 222 of the Communications Act, Western Union as the traditional telegraph monopolist was barred from providing any international record services.

Western Union has no relationship with Western Union International. They are totally separate companies.

The primary thrust of section 222 of the act was to prevent domestic telecommunications companies from competing with international telecommunications service companies and vice versa—to separate the two.

To further complicate matters, both A.T. & T. and the record carriers tend to favor undersea cable communications facilities, as opposed to satellite facilities, because they are allowed to share ownership of cable facilities but have no ownership rights in the satellite system.

Quickly, to summarize and to attempt to explain simply a bizarre and confusing industry structure: internationally there are only two transmission paths, undersea cable and satellites. A.T. & T. basically controls undersea cables while Intelsat and Comsat control the satellites. Nonetheless, A.T. & T. is still responsible for providing Comsat with the bulk of the satellite traffic, 60 percent-plus.

When international traffic arrives domestically, it is handled exclusively by A.T. & T. and/or Western Union. For its part, Western Union leases most of its facilities from A.T. & T., so, therefore, there is a close relationship between Western Union and A.T. & T.

Western Union has no local exchanges.

Senator SPECTER. Is there any relationship between Western Union and A.T. & T. besides the lessee/leasor relationship you speak of?

Mr. PEARCE. None. Therefore, the last mile, the so-called last mile, is handled by A.T. & T. or its associates in the domestic telephone industry.

When international traffic originates domestically it emerges for the most part in the major metropolitan areas served almost exclusively by A.T. & T. This traffic is handled, again exclusively, by A.T. & T. if it is voice traffic, and by Western Union if it is nonvoice traffic.

To add further complication to this curious situation, the FCC has in recent years attempted to open the overseas markets to new value-added carriers such as Graphnet and GTE-Telenet. I understand you will be hearing from those later.

However, these companies have experienced difficulties in breaking into this difficult market structure.

Also, the FCC's Dataphone and Datel decisions represent further international policy shifts and, indeed, further confusion.

In these decisions the FCC said customers could use A.T. & T.'s Dataphone offering to transmit data as well as voice, but only at the user's option, only if the user made that decision.

Similarly, customers could use the IRC's Datel service for voice in addition to record when the customers decided.

These FCC decisions involved so-called permissive uses of Dataphone and Datel, but neither A.T. & T. nor the IRC's were allowed to construct special facilities or alter traffic patterns to exploit these customer options.

Also, in 1979 the Commission attempted to rewrite section 222 of the act in a series of decisions designed to stimulate competition in the provision of international telecommunications services. The second circuit court of appeals, however, decided that the FCC had no authority to unilaterially dump or amend section 222. Consequently, it appears that a legislative solution may be necessary if any substantial change is to be made in the current industry structure.

There is still yet another problem which needs to be explained and discussed. It is the notice of proposed rulemaking in docket 80-632. In this ongoing investigation the Commission is considering taking much broader steps to reorganize international telecommunications.

Last year the Commission, at least tentatively, concluded that separate supply of voice and record offerings is not in the public interest; that this separation which I explained earlier is not in the public interest. It proposed that A.T. & T. be permitted to offer record as well as voice services, and correspondingly that IRC's be allowed to expand into voice services. The Commission, however, did not consider the IRC's weak market power alongside that of A.T. & T.'s, and the Commission, in its haste, forgot to note the following facts:

No. 1, A.T. & T. commands substantial portions of both domestic and overseas telecommunications markets. Consequently, A.T. & T.'s entry into the nonvoice markets would seriously jeopardize the ability of the record carriers to obtain a meaningful share of the market.

Senator SPECTER. Why is that?

Mr. PEARCE. Because of its dominance. I am going to illustrate that in a few moments, Senator.

Two, although the IRC's Datel service has undergone considerable growth since its introduction in the sixties, its current revenue levels are still not substantial. Projected growth in the next 5 years is promising but the service will still not be an effective competitive alternative to A.T. & T.'s overseas services. If A.T. & T. undertakes a major effort to market international Dataphone, Datel may not survive.

Three, the impact of the entry of A.T. & T. or of Western Union into overseas record markets is likely to have a serious effect on the IRC's telex revenues and may result in substantial damage to these firms' earnings and overall financial viability.

Four, A.T. & T. has the financial resources and domestic and international market power to overwhelm the IRC's competitive efforts should it choose to do so. The effects of a broadly based marketing effort by A.T. & T. upon the IRC's could easily destroy one or more of the existing IRC's.

My recommendations, therefore, are as follows:

One, there should be more diligent regulation of overseas services, particularly those of A.T. & T. This regulation should be instituted to minimize current overseas rates without cross-subsidization in an effort to bring about the most equitable rate structures.

Senator SPECTER. How would you amplify that? What do you mean by that?

Mr. PEARCE. I mean that the FCC should apply stricter regulatory vigilance and should pay much closer attention to the accounting methods used by the carriers in this area.

Senator SPECTER. What attention is paid now by the FCC to those matters?

Mr. PEARCE. Very little, if any.

Two, entry into overseas record or voice markets by carriers and service providers that do not possess domestic monopoly services should be encouraged by the FCC. Such planned entry should be accompanied by improved regulatory oversight in order to encourage cost-based rates and increased competition. This new approach should be supported by the FCC in its dealings with the foreign PTT's—the Departments of Post, Telegraph and Telecommunications—to guarantee fair market practices and fair access.

Three, entry of Western Union could be permitted but only after establishment of appropriate structural and regulatory safeguards. These would be developed to assure that any overseas Western Union services would not be cross-subsidized by domestic services. In addition, appropriate interconnection arrangements should be worked out between Western Union and the IRC's beforehand.

Senator SPECTER. What do you mean by item 3?

Mr. PEARCE. Again I am getting to regulatory oversight and accounting procedures.

Senator SPECTER. Would you repeat what you just said as item 3?

Mr. PEARCE. I am referring in item 3 to accounting procedures, vigilance over accounting procedures by the carriers and also perhaps even structural reforms, for example, fully separate subsidiaries. I am saying that entry of Western Union could be permitted, but only after the establishment of appropriate structural and regulatory safeguards.

When I use the word "structural," I am referring to a change in the company structure whereby the company may have to establish a separate subsidiary, or, if not a separate subsidiary, I certainly favor tougher accounting standards which would be overseen by the Federal Communications Commission.

Four, the Commission should allow A.T. & T. to enter the overseas record industry only under special terms and conditions. Clearly issues related to the IRC's interconnection arrangements with A.T. & T. must be resolved prior to FCC approval. Also, serious consideration should be given to the total divestiture from A.T. & T. of A.T. & T. Long Lines International. Even without such divestiture, there should be strict separation of A.T. & T.'s international operations into facilities and services subsidiaries, at the very least, before A.T. & T. is allowed to enter record markets.

Senator **Specter**. Is it your judgment that division of subsidiaries would solve the kinds of problems you anticipate here?

Mr. **Pearce**. It would help significantly, Senator; yes.

Senator **Specter**. And would it go beyond helping significantly to solve that concern?

Mr. **Pearce**. It would go beyond helping. It would not solve it entirely but it would help significantly.

Senator **Specter**. You think it would be satisfactory to use the division of subsidiaries approach.

Mr. **Pearce**. It would indeed.

Senator **Specter**. All right.

Mr. **Pearce**. In summary, A.T. & T.'s international operations are blended into its domestic operations. Consequently, it is impossible to get at the international cost data because A.T. & T. is under absolutely no regulatory obligation, at the moment, to break it out.

Senator **Specter**. Mr. Pearce, is there any current barrier to A.T. & T. entering the international record carrier market?

Mr. **Pearce**. There is, but the Datel decisions of 1979 weaken that barrier, although those were permissive decisions, as I have explained, and this latest Commission inquiry which is underway would obliterate those distinctions completely so that A.T. & T. is currently on the verge of breaking into the record market in a very significant way, and that is the danger. That is the danger to many of the witnesses that you will be hearing from later today.

Over the last several years, for example, A.T. & T. has made very high rates of return on its international voice traffic—15.5 percent in 1977, 23 percent in 1978, and 36.5 percent in 1979.

Senator **Specter**. How do you account for the sharp rise?

Mr. **Pearce**. Because of the dramatically increasing traffic. It is a very prosperous growth industry and that is why there is a great deal of interest.

Senator **Specter**. What do you consider to be an appropriate return?

Mr. **Pearce**. The FCC considers an appropriate return to be in the region of 12.75 percent.

Senator **Specter**. Do you agree with that?

Mr. **Pearce**. Basically, yes. It is possibly a bit low, but I would rather have it around there than at 36.5 percent.

Senator **Specter**. When you say "possibly a bit low," what would be the maximum upward revenue you would consider reasonable?

Mr. **Pearce**. 14.5 percent.

This is why A.T. & T. is able to propose a generous 35-percent reduction in rates right now. This is currently before the Commission.

On leased channels A.T. & T. made a 22.1-percent return in 1979.

Senator **Specter**. With a 35-percent reduced rate, where would that leave their profit picture?

Mr. **Pearce**. It is not known at this stage because you can look at it only after the fact, so to speak. This is the way—ex post facto—that the FCC does it. It depends on where the traffic patterns are as a result of this 35-percent reduction.

Senator **Specter**. Can you give us a guesstimate?

Mr. PEARCE. I have no idea at this stage. I do not like to make future traffic projections, although traffic is increasing at approximately 25 percent per annum.

There are tempting opportunities for anticompetitive behavior under this structure. Under present and projected FCC policy, A.T. & T. could gain a monopoly over all international traffic. That, to me, is deregulation, but it is certainly not competition.

Under the FCC's proposed policies in docket 80-632, Telex could be totally eliminated by A.T. & T.'s entry, especially if Dataphone is launched and marketed properly by A.T. & T.

In conclusion, the differences between the way we handle international telecommunications in the United States and the way they are handled overseas differs sharply. The differences are fundamental, involving free enterprise on our part versus national ownership on the part of the overseas countries, and they are not likely to be resolved, ever.

Consequently, any attempts by the FCC or, indeed, by the Congress, to introduce competition into the international telecommunications field will prove difficult if not impossible.

In addition, facilities planning issues and problems over competing technologies, satellite versus cable, for example, are not easily resolved, again because of vested international interests.

Nonetheless, the basic assumption that underlies the industry is not open to serious debate. No one questions that international telecommunications services are an indispensable part of the social, political, and economic fabric of world society. That is why you are to be congratulated today for beginning this series of hearings on this vitally important issue.

Thank you very much for inviting me to participate.

Senator SPECTER. Mr. Pearce, what do you think the impact would be of Western Union entering the international market?

Mr. PEARCE. Western Union has a distinct competitive advantage, as I have tried to suggest, because it handles the domestic origination of nonvoice traffic, so therefore, if it were allowed to enter, it could theoretically and pragmatically favor itself, and it would be tempted to do so in my opinion.

Senator SPECTER. What would your expectation be as to the competition between Western Union and A.T. & T. on the international market if Western Union entered it?

Mr. PEARCE. Clearly in the league table of power, A.T. & T. is a clear first with Western Union a very distinct second. However, I would think that Western Union would be able to survive because of its historically domestic connection with nonvoice traffic.

Senator SPECTER. Is it possible through the regulatory process to avoid the crutch of their domestic advantage?

Mr. PEARCE. Which A.T. & T. has?

Senator SPECTER. Which Western Union has.

Mr. PEARCE. It is possible—and I believe it is always possible—to structure an industry and to regulate an industry in such a way that you can eliminate, or help reduce, those incentives for anticompetitive behavior. That is why I would suggest and recommend not only structural remedies but also very strict accounting vigilance by the Federal Communications Commission. This has been sadly lacking in the last 20 years, and indeed the uniform system of accounts, which is currently undergoing review, has not generally, recognized as a top priority issue at the FCC.

Senator SPECTER. How do you account for the FCC's failure to act on these questions, which you characterize as being so important and where they are in your judgment so derelict?

Mr. PEARCE. Largely because they have had serious domestic problems to deal with, largely because of this very complicated industry structure in this country, and also because of the vastly different structure in Western Europe, and, indeed, throughout the rest of the world.

The FCC does not have a great deal of international sensitivity, and it has to work through the Department of State and National Telecommunications and Information Administration. Indeed, there are many people, including people on Capitol Hill, who would like to take international telecommunications responsibilities out of the hands of the Federal Communications Commission.

Senator SPECTER. Thank you very much for providing this testimony on this very important and even more complicated subject. We will be submitting questions to you and would appreciate your written responses. There is a very ambitious array of witnesses at the moment which precludes our asking you all the questions which the staff has prepared and on which we would like your expert guidance.

Mr. PEARCE. I would be more than happy to do that, and also I will provide you with appropriate citations.

Senator SPECTER. A copy of your written statement will be incorporated in the record.

[Material follows:]

STATEMENT OF ALAN PEARCE, PH. D., TELECOMMUNICATIONS ECONOMIST

Policymaking in international telecommunications is much more difficult and complicated than it is in domestic telecommunications. The reasons for this are obvious: facilities planning issues affect the sovereign rights of the many nations of the world thus making total international accord and system optimization an impossible dream. Consequently, the many political, governmental, technological, and economic problems are seldom resolved to anyone's satisfaction.

The nations of the world—understandably—have widely differing needs and policy goals. Most countries are not heavily involved in the transoceanic routes and facilities that are used predominantly by the United States, Canada, and a few Western European countries. As a result, they are not overly concerned with service rates and service costs as a method to determine the optimal mix of cables and satellites. Some nations of the world—and in particular those in Western Europe—have a greater stake in cable manufacture than they do in satellite technology, while most nations have no particular stake in either.

In many countries of the world, the revenues derived from international telecommunications are used to cross-subsidize chronic operating deficits in domestic telecommunications and postal services. These revenue considerations tend to result in higher international rates.

Additionally, many of the world's emerging nations are becoming increasingly interested in satellites as a means of providing an efficient and low cost modern international domestic telecommunications system.

So far as industry structure is concerned, International Telecommunications Services in the United States have traditionally been handled by a government regulated cartel—a cartel dominated & controlled by AT&T.

The Federal Communications Commission has allowed AT&T to exclusively handle all telephone, or voice, traffic to all foreign points. Other companies, known as "record carriers"—which is old fashioned regulatory parlance for telegraph or so-called non-voice traffic—include RCA Globcom, AT&T Worldcom, Western Union International (a subsidiary of Xerox), TRT Telecommunications (a subsidiary of United Brands), French Telegraph, and U.S. Liberia Radio. RCA, IT&T, and Western Union International are the big three record carriers with international revenue shares of 36 percent, 34 percent, and 22 percent respectively—a total of 92 percent. The other three carriers are insignificant, with French Cable, for example, having only a one percent share of total overseas record services revenues. In revenues, AT&T grosses over $1 billion while the IRC's gross $400 plus between them.

Among the other international players in the provision of international telecommunications facilities is Comsat, the Communications Satellite Corporation. Comsat is an independent, publicly owned company established by the Congress in 1962 to represent the U.S. in what became INTELSAT, the 105 country International Satellite Consortium that manages today's global communications satellite system.

Under Section 222 of the Communications Act, Western Union, as the traditional domestic telegraph monopolist, was barred from providing any international record services.

Western Union has no relationship with Western Union International—they are totally separate companies and are not related in any way.

The primary thrust of Section 222 of the Act was to prevent domestic telecommunications companies from competing with international telecommunications service companies and vice versa.

To further complicate matters, both AT&T and the record carriers tend to favor undersea cable communications facilities, as opposed to satellite facilities, because they are allowed to share ownership of cable facilities, but have no ownership rights in the satellite system.

To quickly summarize and to attempt to explain simply a bizarre and confusing industry structure—Internationally, there are only two transmission paths, undersea cable and satellites. AT&T basically controls undersea cables while Intelsat and Comsat control the satellites. Nonetheless, AT&T is still responsible for providing Comsat with the bulk of the satellite traffic—60 percent plus.

When international traffic arrives domestically, it is handled exclusively by AT&T and/or Western Union. For its part, Western Union leases most of its facilities from AT&T. Western Union has no local exchanges, so the "last mile" is handled by AT&T or its associates in the domestic telephone industry.

When international traffic originates domestically, it emerges, for the most part, in the major metropolitan areas—served, almost exclusively, by AT&T. This traffic is handled exclusively by AT&T if it is voice traffic, and by Western Union if it is non-voice.

To add further complication to this curious situation, the FCC has, in recent years, attempted to open the overseas markets to new value-added carriers, such as Graphnet and GTE-Telenet. But these companies have experienced difficulties in breaking into the international market.

Also, the FCC's *Dataphone* and *Datel* decisions of 1979 represent further international policy shifts.

In these decisions, the FCC said that customers could use AT&T's *Dataphone* offering to transmit data, rather than just voice communications, but only at the user's option.

Similarly, customers could use the IRCs Datel service for voice (in addition to record) traffic requirements.

These FCC decisions involved so-called "permissive" uses of Dataphone and Datel. Neither AT&T nor the IRCs were allowed to construct special facilities or alter traffic patterns to exploit these customer options.

Also in 1979, the Commission attempted to rewrite S. 222 of the Act in a series of decisions designed to stimulate competition in the provision of international telecommunications services. The Second Circuit Court of Appeals, however, decided that the FCC had no authority to unilaterally dump or amend S. 222. Consequently, it appears that a legislative solution may be necessary if any substantial change is to be made in the current structure.

There is still yet another problem that needs to be explained and discussed. It is the Notice of Proposed Rulemaking in Docket 80-632. In this ongoing investigation the Commission is considering taking much broader steps to reorganize international telecommunications.

Last year, the Commission—at least tentatively—concluded that separate supply of voice and record offerings is not in the public interest. It proposed that AT&T be permitted to offer record as well as voice services, and, correspondingly, that the IRCs be allowed to expand into voice services.

The Commission, however, did not consider the IRCs weak market power alongside of AT&Ts.

The Commission, in its haste, forgot to note the following facts:

1. AT&T commands substantial portions of both domestic and overseas telecommunications markets. Consequently, AT&T's entry into the non-voice markets would seriously jeopardize the ability of the record carriers to obtain a meaningful share of the market.

2. Although the IRCs Datel service has undergone considerable growth since its introduction in the 1960s, its current revenue levels are still not substantial. Projected growth in the next five years will be promising, but the service will still not be an effective competitive alternative to AT&T's overseas services. If AT&T undertakes a major effort to market international Dataphone, Datel may not survive.

3. The impact of the entry of AT&T or Western Union into overseas record markets is likely to have a serious effect on the IRCs Telex revenues, and may result in substantial damage to these firms earnings and overall financial viability.

4. AT&T has the financial resources, and domestic and international market power to overwhelm the IRCs competitive efforts should it choose to do so. The effects of a broadly based marketing effort by AT&T upon the IRCs could easily destroy one or more of the existing IRCs.

RECOMMENDATIONS

1. There should be more diligent regulation of overseas services, particularly those of AT&T. This regulation should be instituted to minimize current overseas rates, without cross subsidization, in an effort to bring about the most equitable rate structures.

2. Entry into overseas record or voice markets by carriers service providers that do not possess domestic monopoly services should be encouraged by the FCC. Such planned entry should be accompanied by improved regulatory oversight in order to encourage cost based rates and increased competition. This new approach should be supported by the FCC in its dealings with the foreign PTTS—the Dept of Post, Telegraph and Telecommunications to guarantee fair market practices and access.

3. Entry by Western Union could be permitted but only after establishment of appropriate structural and regulatory safeguards. These would be developed to assure that any overseas Western Union services would not be cross subsidized by domestic services. In addition, appropriate interconnection arrangements should be worked out between Western Union and the IRCs beforehand.

4. The Commission should only allow AT&T to enter the overseas record industry under special terms and conditions. Clearly issues related to the IRCs interconnection arrangements with AT&T must be resolved prior to FCC approval. Also, serious consideration should be given to the total divestiture from AT&T of AT&T Long Lines International. Even without such a divestiture, there should be strict separation of AT&T's international operations into facilities and services subsidiaries—at the very least—before AT&T is allowed to enter record markets.

In summary, AT&T's international operations are blended into its domestic operations. Consequently, it is impossible to get at the international cost data because AT&T is under absolutely no regulatory obligation to break it out. Over the last several years AT&T has made very high rates of return on its international voice traffic—15.5 percent in 1977, 23 percent in 1978, and 36.5 percent in 1979. This is why AT&T is able to propose a generous 35 percent obligation in rates. On local channels, AT&T made a 22.1 percent return in 1979.

Consequently, there are tempting opportunities for anti-competitive behavior. Under present and projected FCC policy, AT&T could gain a monopoly over all international traffic—that, to me, is deregulation but it's certainly not competition.

Under the FCC's proposed policies in Docket 80-632, Telex could be totally eliminated by AT&T competition, especially if Dataphone is launched and marketed properly by AT&T.

In conclusion, the differences between the way we handle international telecommunications in the United States and the way they are handled overseas differs sharply.

The differences are fundamental, involving free enterprise versus national ownership. And they are not likely to be resolved—ever. Consequently, any attempts by the FCC or—indeed—by the Congress to introduce competition into the international telecommunications field will prove difficult, if not impossible.

In addition, facilities planning issues and problems over competing technologies, satellite versus cable, are not easily resolved, again because of vested international interests. Defense and diplomatic considerations also play major roles in international telecommunications policy planning, and tend to add further complicating factors.

For all of these reasons, policy decisions will be difficult to resolve and will be impossible to resolve to the satisfaction of all parties concerned.

Nonetheless, the basic assumption that underlies the industry is not open to serious debate—no one questions that international telecommunications services are an indispensable part of the social, political, and economic fabric of world society. These services must not only be maintained but should be substantially improved. National security, foreign policy, and the burgeoning demands of private industry, particularly international banking and the multinational corporations, point to the need for an improved and expanded system of international telecommunications.

That is why you are to be congratulated today for beginning a series of hearings on this vitally important issue.

Thank you very much for inviting me to participate.

Senator **Specter**. We now would like to call a panel consisting of Mr. George Knapp, president of ITT World Communications, Mr. Robert Conn, executive vice president of Western Union International; and Mr. Eugene Murphy, chairman of the board, RCA Global Communications, Inc.

We appreciate your appearances here this morning, gentlemen. We have received your written statements. It is the practice of the committee to request that your written statements be summarized, hitting the highlights, because of the very large number of witnesses which we have and the area we are trying to cover, leaving as much opportunity as practical for questions.

Mr. Knapp, would you identify yourself, please?

STATEMENT OF GEORGE KNAPP, VICE PRESIDENT, ITT WORLD COMMUNICATIONS, NEW YORK, N.Y.

Mr. **Knapp**. Thank you, Mr. Chairman.

As an ITT vice president and group executive of its communications operating companies, I represent the ITT World Communications, a leading international record carrier, or IRC, of which I am also chairman of the board.

ITT supports your request for referral of S. 271 and S. 898 and appreciates your efforts through these hearings to shed some light on monopoly/competitive issues which are sometimes ignored by those who would reshape telecommunications policy in a simplistic fashion.

As I testified before the Communications Subcommittee of the Senate on S. 271 in February, I did not think Congress would intend to allow monopolists like Western Union, A.T. & T., Comsat, or even the Postal Service, either singly or in combination, to unfairly dominate either through sheer market power or through control of bottleneck facilities competitive markets which they may enter. ITT supports changing telecommunications policy to foster the competition rather than monopoly. However, because of the interrelated nature of all telecommunications markets, we see no way to deal with such change without first deciding under what conditions the existing holder of a Government-granted or fostered monopoly should be allowed to enter competitive markets. Your introduction of S. 1159 indicates that you, too, are concerned about monopoly domination.

In the interest of allowing more time for questions, as you suggest, I will summarize my testimony but request the full text be part of the record.

During the past few years several proposals have been made in Congress to change the way communications are provided in international and domestic markets. Such proposals have varied and included comprehensive bills that would restructure the entire telecommunications industry such as S. 611, bills that would treat only domestic regulations such as H.R. 6121, and "one-liners" that would repeal section 222 of the Communications Act.

The FCC has tried to work within the 1934 act to introduce competition on its own and has had mixed success. The principal reason Congress and the FCC have been unable successfully to change telecommunications policy is that the monopoly competition issues have not been adequately faced up front.

Concentrating on the repeal of section 222 solely for the special interests of Western Union can only compound the general problem.

There are three basic problems associated with the repeal of section 222 which are compounded by Western Union's negative attitude toward the introduction of competition into its monopoly markets. One has to do with the Western Union, Government-sanctioned, monopoly position in the domestic telex/TWX market. Another has to do with the nature of foreign agreements which make international services possible. The third has to do with the FCC's unwillingness or inability to deal promptly and effectively with the facts of monopoly domination.

Western Union's monopoly position in domestic services has allowed it over the years to establish a customer base of teleprinters, connected directly to Western Union's switches, which allows it to control about half of the total international telex market. Because the IRC's do not have effective interconnection to Western Union's domestic system and do not have FCC authorizations to provide unlimited domestic services, the international record carriers could not provide effective competition to Western Union if section 222 were repealed today, and Western Union authorized to provide international record service, because the IRC's could not deal with a large portion of the prospective customers. Also note that authorization to provide intrastate services is not within the jurisdiction of the FCC.

Because most foreign telecommunications systems are governmental or quasi-governmental monopolies, no international service can be provided except in partnership with a foreign administration which usually must follow its government's policy. In many cases, this policy includes interconnection with the fewest number of U.S. carriers possible and the use of international revenues to subsidize other national services.

Despite our Government's procompetitive telecommunications policy, many, if not most, of the foreign administrations would like nothing better than to sign operating agreements with Western Union in the hope that this monopolist would eventually reduce the number of carriers seeking interconnection. Some might look forward to the day when prices for international services could more easily be kept high for lack of competition.

Throughout the debate over the repeal of section 222 during the last few years there seems to be a myopia on the part of some, notably the FCC and some members of the Commerce Committee, that does not allow them to recognize that Western Union does in fact dominate the domestic record market and could use this special advantage to dominate the international telex market if allowed entry via S. 271. I am not sure what causes this myopia, which I like to refer to as a Western Union blind spot, but it goes to the heart of the problem, which is dominance.

Senator SPECTER. Just how would that come about?

Mr. KNAPP. Western Union today has approximately 135,000 teleprinters connected to its network. Over half, approximately half, of the traffic international today originates on those teleprinters. They therefore control over 50 percent of the international traffic directly on their printers. That is pure and simple.

Senator SPECTER. So that is the reason you are suggesting that the IRC's could not compete effectively?

Mr. KNAPP. A further reason because of the monopoly. I will get to those points further in my comments, Senator.

Senator SPECTER. All right.

Mr. KNAPP. In debate last week on whether S. 271 should be referred to this committee, one Senator opposing referral stated Western Union was "no longer even a monopoly in the United States." Another prominent Senator categorically stated that "Western Union no longer has a monopoly in the domestic market." If these statements were intended to refer to Western Union's general position in the entire telecommunications market, they may be accurate.

However, that is not the issue. The issue is whether Western Union has dominance in the domestic public switched record services market consisting almost entirely of TWX and telex service which the Commission has recognized as a separate and distinct submarket in its competitive carrier rulemaking.

Senator MATHIAS. Are you going to touch upon percentages of the market in each of these categories you mentioned?

Mr. KNAPP. Yes, sir. I have attached to my testimony the current shares of market, not only currently but over the entire period of time.

Senator MATHIAS. I don't want to interrupt you if that is otherwise available.

Mr. KNAPP. As the Commission stated in the first report and order in that proceeding, it "proposed to classify Western Union as a dominant carrier because of its virtual de facto monopoly of telex/TWX service."

The determination of the FCC in its domestic deregulation inquiry is consistent with that made last year by the U.S. court of appeals. This court stated in barring a patently illegal attempt by Western Union to finesse section 222 by providing international telex service via Canada and Mexico that Western Union's dominance in the domestic market still exists.

As recently as January of 1981, the FCC stated that Western Union "has solidified its position for more than 35 years as a de facto monopoly."

ITT Worldcom submits that this committee, charged with the responsibility for antitrust oversight, must consider the conclusions of the responsible regulatory agency, in proceedings based on the record, as to whether switched record services constitute a distinct and relevant submarket and whether Western Union is dominant in that submarket.

A demonstration of the manner in which Western Union can be expected to misuse its monopoly power was recently brought to light in docket No. 78-97 before the Commission, which is a proceeding to determine the lawfulness of charges established by Western Union for telex and TWX services provided to the IRC's and other domestic subscribers.

From the inception of this case, the record carriers contended that the telex and TWX interconnection services provided to them by Western Union cost Western Union substantially less than the cost of providing similar services to the public, and that, therefore, Western Union's charges to the IRC's should be substantially less than its corresponding charges to the general public.

Western Union has repeatedly and vigorously denied knowledge of any meaningful cost differences in providing telex and TWX services to record carriers. Nevertheless, some three years into the course of this proceeding, it was revealed that at least since December of 1977, and probably before that, Western Union has been in possession of evidence which it did not furnish, though asked to do so in discovery, that unmistakably supported the claims of the record carriers.

The evidence shows, for example, that by one of several generally similar Western Union cost calculations, Western Union's usage earnings for 1977 follow a classic monopolistic pattern ranging from only a 0.5 percent return for intrastate services to 150 percent return for services to the IRC's.

And, in at least one provable instance discovered so far Western Union provided information to a State agency that could demonstrate these dramatically disparate earnings between the three categories of service.

It seems obvious that Western Union, a domestic monopoly, deliberately structured its rates so as to receive an artifically low rate of return from intrastate service where it faced potential competition and artificially high rates of return from the provision of service to the record carriers who had no alternative but to use Western Union's competitive services to reach the hinterland users.

Senator SPECTER. How did it implement that artificial approach, as you just described it?

Mr. KNAPP. It insisted before the FCC that it had no way of making a study, and therefore the presumption was that the costs were equal whether service was provided to a single individual customer or to one of the IRC's. That view prevailed before the Commission. The Commission did not pursue the matter.

Senator SPECTER. Did someone challenge that assertion before the Commission?

Mr. KNAPP. Yes, sir. Certainly ITT challenged it. Unfortunately, the decision went against ITT.

The best way to make sure truly effective competition continues in the international market is to exclude Western Union as long as it maintains a monopoly in the relevant switched record service submarket. In effect, S. 1159 would accomplish this. However, there are five specific conditions which would help to insure a fair competitive market when Western Union does ultimately enter the international arena.

First, Western Union must provide effective, nondiscriminatory, and reasonably priced interconnection to the international record carriers. It does not do that today.

No. 2, the IRC's must be authorized to provide domestic services by elimination of the "gateway" concept. The FCC by policy has restricted us to specific gateways. All gateways should be eliminated.

No. 3, there must be provision for reasonable transition to truly effective competition in the domestic telex/TWX market. S. 1159 would send a congressional message to the FCC that such findings are necessary.

No. 4, an equitable distribution of unrouted telegraph traffic is needed during some period of transition.

No. 5, the jurisdiction over intrastate record services must be shifted to the FCC to facilitate domestic competition. Today it is under the jurisdiction of the individual 50 States.

Most of these problems were acknowledged in the report issued by the Commerce Committee on S. 271. However, it concluded that the FCC had the authority to solve such problems and, therefore, it was not necessary to address them in the legislation. It has been repeatedly demonstrated that Western Union is prone to exploit its monopoly position, and our experience is that the FCC has been reluctant to use its powers to stop it.

May I conclude by summarizing the points I wish to make?

No. 1, Western Union's entry into the international market, as long as it retains its domestic telex/TWX monopoly, will not foster competition.

No. 2, Western Union does enjoy a virtual monopoly in domestic telex/TWX today. This is the point of my presentation.

No. 3, the Western Union problem is no different than the entry of any monopolist into a competitive market and must be solved prior to allowing such entry, a principle that would apply to S. 898 as well.

No. 4, Western Union has demonstrated a pattern of anticompetitive behavior that justifies ITT's concern over its entry.

No. 5, the passage of S. 1159 would help insure that effective competition would continue in the international record market.

No. 6, there are a few specific conditions that I previously mentioned that should be added either to S. 1159 and/or S. 271 in order to preserve effective competition when ultimately Western Union is permitted to go overseas.

I would again like to thank you for bringing monopoly/competitive issues to the attention of your colleagues in the Senate, and I would be happy to cooperate with this committee and its staff in its efforts to overcome the special efforts being made on behalf of Western Union or any other entity enjoying monopoly advantages.

Mr. Chairman, I thank you for the opportunity.

Senator **Specter**. Thank you, Mr. Knapp.

Senator Mathias has some questions.

Senator **Mathias**. I am interested in your version of how we got into the posture that we are in now. This is not a situation which suddenly developed. It had developed as a result of decisions made over the last 20 or 25 years. I wonder if you could give us a very brief historical sketch on the original determinations of what the role of Western Union would be, and then how that would be affected by the current proposal.

Mr. **KNAPP**. Prior to 1943 there was a variety of carriers in the international telecommunications market, mostly radio carriers but a few cable carriers. It became apparent that with the growing dominance of Western Union in the domestic market that it had an unfair advantage—it had a monopoly dominance, if you will—of the record traffic within the United States.

Senator **MATHIAS**. As I recall, its last principal competitor in the domestic market was Postal Telegraph?

Mr. **KNAPP**. I do not know the answer to that. Perhaps Mr. Murphy would know.

Mr. **MURPHY**. Yes; that is correct.

Mr. **KNAPP**. I do not know who its last competitor was. However, at the point in time that the Congress enacted section 222 Western Union traded, if you will, its competitive position internationally for a complete monopoly situation in the record market as part of the introduction of section 222 and as part of its divestiture of its international facilities.

The point of my presentation basically is that those same conditions prevail today. Western Union has a monopoly in the TWX/telex market today, and that is precisely the market we are talking about.

We are not talking about the fact that Western Union today is a specialized common carrier, for example, in the voice field in the United States, which it is. It is one of the specialized common carriers competing against the A.T. & T. long lines.

We are talking about the specific market of the international record carriers, which is telex/TWX, versus the domestic monopoly at Western Union, which is solely telex and TWX.

Senator **MATHIAS**. What you are saying is that historically, the antitrust enforcement officials in the country have accepted Western Union's dominance—or monopoly, if that is the accurate word—of the domestic market in exchange for the arrangements that were made in the international market.

Mr. **KNAPP**. That is correct.

Senator **MATHIAS**. It is your testimony that the conditions have not changed in the intervening period.

Mr. **KNAPP**. That is correct, for the relevant market.

Senator **MATHIAS**. Therefore, the proposal to change the arrangements in the international market seem to be without any economic foundation.

Mr. **KNAPP**. That is correct, Senator.

Senator **MATHIAS**. That is the whole case in a nutshell.

Mr. **KNAPP**. That is right. That seems to have been recognized in S. 1159, which suggests that once the domestic monopoly of the telegraph carrier is reduced below 60 percent, then it would be permitted to participate in the international competitive market.

Senator **MATHIAS**. What rationale do you see—and obviously you are opposed to it—what rationale do you perceive that is offered for this step to be taken at this time, which would reverse a previous decision without any reversal of the factual background?

Mr. **KNAPP**. I do not truly understand what is behind the motivations and the actions to repeal section 222 at this time.

Senator MATHIAS. Thank you, Mr. Chairman.

Senator SPECTER. Thank you very much, Senator Mathias.

Our next witness is Mr. Robert Conn, executive vice president, Western Union International.

Mr. Conn, I think there might be some interest in starting your testimony by telling us how the similarity arises between your name and Western Union's name, notwithstanding the absence as I understand it, of any connection between the companies.

STATEMENT OF ROBERT CONN, EXECUTIVE VICE PRESIDENT, WESTERN UNION INTERNATIONAL, INC., NEW YORK, N.Y.

Mr. CONN. Yes; I will explain why my company's name is similar to that of the domestic Western Union Telegraph Co., with whom we have no affiliation.

I want to say good morning to Chairman Thurmond and the members of this committee. It is indeed an honor to appear before you this morning.

I am Robert E. Conn, executive vice president of Western Union International, Inc. WUI, as we are known in the marketplace, is one of the major international record carriers.

Senator SPECTER. Would you hold just one moment?

ESTABLISHMENT OF AN INDEPENDENT WUI

Mr. CONN. Yes.

Mr. Chairman, in specific answer to your question, section 222 was the birthright of my company. My company, WUI, was established in September of 1963 pursuant to section 222's mandate that the domestic monopoly Western Union get out of the international business. That mandate was issued by Congress in 1943 when it bestowed monopoly privileges with antitrust immunity upon the Western Union Telegraph Co.

However, Western Union was not willing to keep its share of the bargain by getting out of the international business. Western Union delayed—and the FCC dockets support my statement—exiting from the international business for 20 years. During this period it engaged in anticompetitive conduct against the independent international companies to such a degree that the FCC put intense pressure on Western Union to exit from the international market. In the meantime, Western Union lobbied continuously before the Congress to repeal its obligation of divestiture of its international business.

When we were created as a separate, independent company in 1963, Western Union signed a covenant for our benefit, which was approved by the FCC. The FCC had to approve all the transactions that led to the divestiture.

Western Union covenanted not to compete in the international business directly or indirectly with the new, independent WUI for 25 years. Those 25 years will be up September 30, 1988. However, again Western Union did not pay very much attention to its bargain.

Senator SPECTER. Was Western Union International then the business entity which had been Western Union's operation in the international field?

Mr. CONN. Yes, sir. We were known then as the cable division of Western Union. We bring, if you will forgive a little propaganda, over 100 years of unbroken experience in international operations.

Senator SPECTER. I think there may be some of that in other quarters as well in these hearings.

Mr. CONN. Yes.

Historically we are probably the oldest international record carrier. By contract we received the right in the divestiture transaction to keep the words "Western Union" in our name because, in our opinion, we had developed the good will abroad. We feel we have retained, indeed enhanced, that good will during the last 18 years.

Incidentally, to the overseas administrations, Western Union means WUI. We owned the original telegraph cables laid in the mid-1800's, which were replaced in the mid-1900's by the more modern telephone-type coaxial cables in which we also have an ownership interest. More recently, we have been permitted to lease, but not to own, communications satellites.

Senator SPECTER. If Western Union is permitted to come into the international field, are they not likely to get a lot of your business by mistaken identity or vice versa?

Mr. CONN. Yes, sir. But I doubt that the "vice versa" will apply. I think they are going to get a lot of our business, not only by mistaken identity, but by the anticompetitive conduct they have been engaging in.

Senator SPECTER. That is the subject matter of the hearing, but I was wondering if the genesis of your name and its similarity, if not virtual identity, might create some confusion from which your company might be the beneficiary, given the greater dominance of Western Union's position as contrasted with Western Union International's position. Would you disagree with that evaluation?

Mr. CONN. No, sir. I think in our early days after we became an independent company we did benefit from the similarity in names. Again, I think we earned that right through our international promotions, but we did indeed benefit. More recently, the sophisticated users know the difference between the two companies.

Senator SPECTER. What would happen to the names if Western Union came into the international field?

Mr. CONN. By contract we have the right to use our name, and they their own name. However, the similarity would, indeed, lead to some confusion.

I would now ask the committee, because I am going to summarize, to accept for the record my entire testimony of 32 pages.

Senator SPECTER. It shall be incorporated in the record and printed in full following the oral presentation of the panel.

Mr. CONN. Thank you, sir.

Also, as a preliminary matter, I request the opportunity to submit prompt written comments if we deem it necessary to complete the record and perhaps to respond to some of the witnesses who will follow me.

Senator SPECTER. We would be pleased to receive that. We will make it part of the record.

PRO-COMPETITIVE SAFEGUARDS AND REASONABLE TRANSITION PERIOD

Mr. CONN. Thank you.

In summary, sir, I would like to underscore that the entry of the domestic telegraph monopoly carrier into the competitive international record carrier market without pro-competitive safeguards will be destructive of competition in the international market.

As a result of governmental actions over the years, Western Union, the domestic monopolist, substantially controls the public's access to the international record carriers. Consequently, Western Union is capable of diverting about half of the business of the international record carriers when Western Union enters the international record carrier market.

Congress wisely barred such market entry many years ago and has not repealed this constraint despite massive and prolonged efforts by Western Union to gain repeal of the statutory bar.

Western Union's domestic dominance was indeed bestowed upon it by the Government, which also nurtured and protected that dominance for nearly 40 years. Therefore, Congress will not be writing on a clean slate if it enacts new legislation authorizing a further expansion of Western Union's scope of operations.

There must be minimal pro-competitive safeguards if the dominant Western Union were to enter the international market. There are at least four safeguards that we would recommend.

First, a reasonable transition period is essential to accord the international record carriers an opportunity to expand and develop their previously restricted scope of operations in order to withstand the onslaught of the international market entry by the domestic telegraph monopoly carrier.

Senator SPECTER. What would you say that reasonable transition period would be?

Mr. CONN. I am not prepared at this point to quantify that. However, I will do so in our written comments, sir. I stress that we are not seeking delay for the sake of delay. We are seeking a reasonable period in which to gear up for Western Union's onslaught. We need that time because the FCC, not by law but by policy, had refused for nearly a decade to permit us to expand beyond the narrow confines of a handful of gateway cities.

Senator SPECTER. We would like you to be as specific as you can after you have a chance to reflect on it, Mr. Conn.

Mr. CONN. Yes, I will do so in our written comments.

Any abrupt flash cut permitting immediate market entry by Western Union would enable it to extend its domestic dominance into the international market and substantially lessen competition in that market.

I respectfully refer the committee to pages 27 through 29 of my full testimony which show the steps that WUI must be free to take if we are to have any chance of successfully competing with the domestic monopolist before it invades our market.

Second, we recommend as a pro-competitive safeguard the right of interconnection to Western Union's network and the right for the public to have access to our services. Western Union controls bottleneck facilities which constrict the flow of about half of the total volume of U.S. international telex messages.

We have a case study, cited in my full testimony, of 5 years of frustration and failure for both the Federal Communications Commission and the international record carriers in achieving interconnection with Western Union.

Any new legislation should mandate that Western Union provide both fair and nondiscriminatory interconnection with the respective telex networks of each international record carrier. The public throughout the United States must have access to the international record carrier of its choice unimpeded by Western Union, which now occupies the position of a communications gatekeeper.

During the 1979–80 time frame when Western Union operated unlawfully in the international telex market, the domestic monopolist demonstrated how it could manipulate its gatekeeper role to divert international telex messages to a combination of its own unlawful international route and, preferentially, to a single international carrier which was willing to cooperate in promoting Western Union's unlawful international market entry.

The third safeguard which I would recommend would be equitable and nondiscriminatory message interchange between Western Union and the independent international carriers. If Western Union were to occupy the dual role of a dominant domestic record carrier and a competitive international record carrier, a natural tendency would exist for the company to divert overseas telegrams to its own international arm. Indeed, the dockets of the FCC are replete with such conduct during the 1943–63 time frame when Western Union occupied such a dual role. This is covered in some detail in my full testimony.

Accordingly, any new legislation should mandate that Western Union interchange overseas telegrams with the international carriers on an equitable and nondiscriminatory basis.

Now to the fourth safeguard. There must be unrestricted domestic market entry for the international record carriers. Any new legislation should clearly indicate that the international carriers are not barred from entering the domestic marketplace. Although current laws do not bar domestic market entry by these carriers, the FCC has generally precluded such entry as a matter of policy, as explained in my full testimony.

During the transition period that I mentioned earlier the international record carriers should be accorded the opportunity of unlimited domestic market entry.

JUDICIARY COMMITTEE CAN BE THE COORDINATOR OF CONSISTENT PRO-COMPETITIVE LEGISLATION

Finally, Mr. Chairman, I would like to underscore that fragmentary revision of the laws governing competition and monopolization in the telecommunications industry can lead only to uncertainty and confusion in that industry. The currently pending International Record Carrier Competition Act of 1981, known as S. 271, would summarily repeal the existing statutory bar to Western Union's overseas market entry. No transition period is provided.

Moreover, that bill does not include effective pro-competitive safeguards but, rather, relies upon existing provisions of law which allegedly empower the FCC to impose such safeguards as a condition to any overseas market entry by Western Union.

Paradoxically, another pending bill, the Telecommunications Competition and Deregulation Act of 1981, known as S. 898, would repeal the FCC's authority to regulate Western Union's market entry. The FCC could not, therefore, impose pro-competitive safeguards. Therefore, the combined effect of S. 271 and S. 898 would enable Western Union unilaterally to enter the international marketplace.

Further complicating this flurry of legislative activity is a recent authoritative statement that the Senate Communications Subcommittee will undertake a revision of the statutes governing international telecommunications later this year.

Although that subcommittee is diligently endeavoring to get its job done, some entity in the Senate must assume a coordinating role. Therefore, WUI is grateful that the Judiciary Committee is undertaking its series of hearings on the topic of monopolization and competition in the telecommunications industry.

If there are to be changes in the laws governing this industry, any such changes must be accomplished in a coordinated and consistent fashion. The pendency of seemingly inconsistent legislation and the potential emergence of further relevant legislation is, I am sorry to report, causing confusion and uncertainty in our industry. This result cannot be favorable for the public because the carriers must be able to plan in advance for the provision of innovative and efficient services in order adequately to meet the future needs of the public.

In other words, it is becoming increasingly difficult to plan for the future, to assemble the necessary capital to conduct our business and to serve our public when we are faced with the diversion of half of our revenues by a pending bill.

In conclusion, Senator Specter, we respectfully urge this committee, and through it the entire Senate, to please make certain that any new legislation will enhance, not inhibit, competition in international telecommunications.

Thank you, Mr. Chairman, and all the members of this committee and its diligent staff.

FCC AUTHORITY

Senator SPECTER. Mr. Conn, does the FCC have adequate jurisdiction and authority to put into effect the pro-competitive safeguards which you have asked for?

Mr. CONN. Yes, sir. I believe it does, but it has not been successful to date, although not through its failure to try. My illustration of 5 years of frustration with respect to interconnection shows that the FCC has not succeeded to date. If there is to be new legislation, there should be some teeth put into that legislation to help the FCC.

Senator SPECTER. That was the thrust of the question. You say it does have sufficient jurisdiction and authority now?

Mr. CONN. Yes; it does, sir.

Senator SPECTER. What kind of legislation would you like to see to strengthen the FCC, if that is, in fact, your suggestion?

Mr. Conn. If new legislation were to be enacted repealing section 222—that is the framework I am talking about—then a precondition to Western Union's market entry would be complete fulfillment of all the safeguards that I mentioned, and interconnection in particular. I believe Mr. Pearce testifed earlier this morning to the same effect.

Senator Specter. My question is, does the FCC currently have the jurisdiction and power to do that?

Mr. Conn. The answer is yes, sir.

DIVERSION OF REVENUES TO WESTERN UNION

Senator Specter. You testified that the current legislation would result in a diversion of one-half of your revenue. I believe those were your words.

Are you suggesting that it would cause you to go out of business? Can you survive with one-half of your revenue?

Mr. Conn. I want to be dispassionate, but accurate, in this presentation. I cannot honestly say that we would go out of business. However, Western Union's unconditional market entry would cripple our ability to provide adequate and efficient service to the public. If we lost half of our business to Western Union, we would obviously not save on expenses because we have a fixed plant which was installed to cover the international communications capacity that we now handle, and to cover hopefully what we expect to be an improved market share.

Senator Specter. What I am trying to understand is this: There are two parts to my question. You assert you would lose half of your business. Do you really mean that? If so, can you survive on half of your business?

I would like to understand whether you are saying that if this bill is enacted it is going to drive your company out of business.

Mr. Conn. No; I am not saying it will drive our company out of business, but I do think it will cripple our company.

Senator Specter. It would be very bad, but you could survive?

Mr. Conn. Yes; that is correct. However, in addition to producing a profit, we must provide new and innovative services to the public, and our ability to do so would be seriously crippled by Western Union's unconditioned market entry.

Senator Specter. Mr. Conn, thank you very much. There are quite a number of questions which have been prepared by the staff which time does not permit our asking in light of the very ambitious array of witnesses. Therefore, they will be submitted to you with the request that you respond in writing.

[Material to be supplied follows:]

WUI Inc.
Western Union International

ROBERT E. CONN
Executive Vice President

June 16, 1981

Honorable Strom Thurmond, Chairman
Judiciary Committee
United States Senate
209 Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Thurmond:

Western Union International, Inc. (WUI) appreciated the opportunity to appear before the Judiciary Committee on June 10, 1981, and give testimony on the subject of monopolization and competition in the telecommunications industry.

The record developed by the Committee during its June 10 hearing demonstrates convincingly that:

¶ Immediate and unconditioned international market entry by the dominant domestic Western Union Telegraph Co. will substantially lessen, if not destroy, competition in that market; and

¶ A reasonable transition period, prior to any international market entry by Western Union, is necessary to enable the international record carriers to prepare for any such market entry.

Procompetitive safeguards must be imposed prior to any international market entry by Western Union to ensure that the international record carriers obtain adequate interconnection to Western Union's dominant telex/TWX network, that Western Union engage in equitable message distribution among the international carriers, and that Western Union be restrained from cross-subsidizing any competitive international services with revenues from Western Union's dominant domestic services.

One WUI Plaza • New York, N.Y. 10004 • (212) 363-6404

Most importantly, the only two witnesses not from the industrial sector testified generally in support of the above-enumerated principles.

The Acting Assistant Secretary of Commerce for Communications and Information, National Telecommunications and Information Administration (NTIA), Mr. Dale N. Hatfield, stressed the need for procompetitive safeguards dealing with access, interconnection, and message distribution. Mr. Hatfield also testified that he had no "objection" to a "statutorily imposed moratorium of some reasonable length" (Tr. 105) prior to international market entry by Western Union. Mr. Hatfield was the only witness from the Government to appear.

Mr. Alan Pearce, Independent Telecommunications Policy Consultant, with "no client interest in this area" (Tr. 5), testified that Western Union's international market entry "is likely to have a serious effect on the IRCs' telex revenues and may result in substantial damage to these firms' earnings and overall financial viability". (Tr. 14). Mr. Pearce also stressed the need for procompetitive safeguards to be in place prior to any international market entry by Western Union.

WUI is grateful that the Judiciary Committee is undertaking its series of hearings on the topic of monopolization and competition in the telecommunication industry. We hope that this Committee will fully develop its record and complete its deliberations, and pending that effort, it is our view that the Senate should not act hastily upon the pending bills -- S.271, S.898, and S.1159.

Enclosed for the record of the June 10 hearing are WUI's answers to the written questions received from the Committee's Staff, and WUI's supplement to several matters mentioned during the hearing.

Very truly yours,

Robert E. Conn

Robert E. Conn

Enclosures

cc: All Committee Members

Attachment to WUI
letter of June 16, 1981

QUESTION

Western Union International suggests a transition period to permit the IRCs a reasonable period to prepare for international entry by Western Union. How long a transition period do you think would be necessary, and how would you utilize the transition period?

ANSWER

As was explained in WUI's testimony, the goal of establishing a competitive marketplace in both the domestic and international record communications markets requires that all participants have an opportunity to compete fairly. Specifically, any pro-competitive legislation should contain provisions granting each IRC the ability to: (1) interconnect, on a fair and equitable basis, with the Western Union telex/TWX networks for both domestic and international services; and (2) provide domestic service on its own network.[1]

Once WUI has obtained the necessary interconnection, a transition period of at least one year is necessary to allow for the creation of a truly competitive environment. There are two fundamental reasons for this: (1) the need to establish consumer recognition of new offerings;[2] and (2) the need to obtain any required state certificates to provide intrastate service.

In today's telecommunications environment, consumers are desirous of obtaining as many services as possible from a single source. In this instance, Western Union's networks now are capable of providing all record services -- international via the IRCs, interstate, and intrastate. IRC networks, of course, are currently limited to the provision of international record service.

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[1] WUI currently has authority to provide its international services in 35 cities. It is our assumption that WUI's pending application for an additional 16 cities will be granted promptly, and that WUI will be fully operational in those cities prior to the effective date of any legislation repealing Section 222.

[2] Western Union's long commercial relationship with virtually all U.S. record subscribers places it in a unique competitive posture. In contrast, each IRC has such a relationship with only a small number of customers. It is this fact which requires that Western Union enter the market only after the IRCs have had an opportunity to establish their presence. As Western Union has demonstrated, it can provide international services as soon as it is authorized to do so. Thus deferring its entry for a short period is the only way to ensure the development of a truly competitive market.

During the brief transition period, WUI will make every effort to familiarize consumers with its new position, as both an international and domestic carrier. Considerable efforts from a promotional standpoint will be undertaken to alert companies and individuals to WUI services and the fact that it is now a full-service carrier.

It is reasonable to expect also that existing and potential users of record services will require some time to learn about the new options available to them and make reasoned determinations as to how best to meet their needs. Previously, subscribers did not make such an analysis since only one full-service provider, Western Union, existed.

Finally, many of the WUI innovative service offerings may require state approval prior to initiation. The proposed transition period will enable WUI to obtain any necessary state certificates and initiate its services by the time Western Union enters the market directly as an international carrier.

Thus, a transition period is required in order to permit consumers to become familiar with all potential telecommunications suppliers and their offerings. Once this is accomplished, the marketplace will act to reward those entities which provide the best combination of service and price. Absent such a period, success will be based on established consumer patterns. Thus, the chance of establishing real competition, with all its benefits to the nation, will be lost.

QUESTION

Western Union stated in the Commerce Committee hearing on S.271 that it should not be required to redesign its transmission and switching network to accommodate constantly changing and possibly transitional interconnections requirements of all carriers. Do you agree that there are some extraordinary costs which must be incurred to facilitate full interconnection, and if so, have the IRCs been willing to share those costs?

ANSWERS

There are no extraordinary costs, that we can ascertain, which must be incurred by Western Union in order to accord WUI the interconnections that have been denied to us for more than 5 years. Western Union will not be installing unique equipment to satisfy WUI's requirements which could justify the imposition of the additional charges, the burdensome termination liabilities and the special construction charges that Western Union is demanding. Moreover, because interconnection equipment for WUI, as compared with public subscribers to Western Union's network, is basically interchangeable, there is no basis for Western Union's claim that it would incur extraordinary costs to facilitate interconnection for WUI. Even in New York and San Francisco where WUI already interconnects with Western Union, that company is now attempting to increase WUI's interconnection costs, even though no equipment changes are necessary.

Western Union repeated its exaggerated claims during its testimony on June 10 before the Judiciary Committee. However, Western Union failed to mention its candid position before the FCC that it was not in Western Union's financial interest to facilitate interconnection at additional gateway cities. This is true because it would enable the public to reach the international record carriers expeditiously and economically rather than traversing Western Union's domestic system circuitously, and thus, generating more revenue for Western Union.

QUESTION

The statement has been made that Western Union controls approximately 50% of your domestically originated Telex/TWX traffic. From where do you receive the other 50% of your traffic?

ANSWER

The other 50% of WUI's U.S.-originated, overseas-destined, telex traffic comes from the subscribers to WUI's own telex network which is now operational in 26 U.S. cities.

With respect to overseas-originated, U.S.-destined, telex traffic, WUI's adverse imbalance is even greater. About 55% of this traffic is destined to customers in the U.S. who can only be reached by WUI through Western Union's "bottleneck" facilities. If Western Union were eligible to operate directly overseas, that company could take steps to divert this 55% segment of WUI's business by (1) constricting WUI's traffic flow through Western Union's bottleneck by means of operational and economic strategems; and (2) persuading, if not coercing, overseas administrations to by-pass WUI in favor of Western Union's own overseas circuits.

SUPPLEMENTAL MATERIAL

First Panel

During the appearance of the First Panel on June 10, 1981, consisting of three international record carriers, there was a colloquy between the Honorable Arlen Specter, who was then presiding, and the witnesses. This colloquy may have indicated that Western Union's last domestic record competitor was the Postal Telegraph Company in 1943 (Tr. 37).

However, AT&T was, in fact, Western Union's telex/TWX competitor until the early 1970s when Western Union acquired AT&T's TWX system, pursuant to antitrust immunity under Section 222 of the Communications Act.

Western Union's acquisition of its current telex/TWX monopoly was not only permitted by Section 222, but the Federal Communications Commission actually promoted this transaction for the benefit of Western Union. The FCC publicly disclosed, in 1966, its intention "to prevail upon AT&T and Western Union to effect an agreement on the purchase and sale of the TWX service."1/

After Western Union acquired its telex/TWX monopoly in 1972, it proceeded to increase its interconnection charges to the IRCs by 100-fold, and further substantial interconnection charges are now pending before the FCC.

Western Union Witness

During the appearance of the Western Union witness, there were colloquies between the Honorable Charles McC. Mathias, who was then presiding, and the witness.

Senator Mathias asked about Western Union's message to customers warning that their telex machine repairs would be accorded the lowest priority unless those customers used Western Union's overseas route via Canada/Mexico. Western Union's witness sought to minimize this as an unauthorized act of a salesman who was subsequently disciplined (Tr. 131-132).

In any event, Western Union's course of conduct during the 1979-80 timeframe, when it unlawfully provided international service via Canada/Mexico, was entirely consistent with, and embraced, the above-mentioned coercive sales message.

1/ FCC Report in the Domestic Telegraph Investigation, Docket No. 14650, April 29, 1966.

Western Union lowered the gauntlet against the rule of law when it commenced its unlawful service in September 1979 without seeking FCC authority. In full page advertisements in the The New York Time, Wall Street Journal and Washington Post on October 15, 1979, Western Union announced its indirect overseas telex service via Canada/Mexico and stated:

> "Western Union would like to go overseas directly, but the law says we can't. To prove a point about this obsolete law, ... Western Union recently decided to work out an alternative solution."

The advertisement went on to ask the rhetorical question, "Will we be stopped?", and conceded, "It's possible". However, Western Union invited customers to patronize its new services in the "meanwhile".

When Western Union's overseas service was challenged before the FCC, a principal issue was whether this service via Canada/Mexico was "domestic", as Western Union claimed, or "international" and therefore unlawful, as the IRCs contended. Suddenly, Western Union discarded the name previously used for this service -- "Western Union International Telex Service". Instead, the service was renamed -- "Low Cost Routing Service" -- and "International" was dropped from the name. Even after the U.S. Court of Appeals for the Second Circuit held this international service to be unlawful, Western Union continued to promote it actively in violation of a court order. This led to contempt proceedings before the Second Circuit which condemned Western Union's " contemptuous" conduct and ordered the unlawful service terminated immediately.

Therefore, the coercive sales message was merely part of Western Union's overall campaign against both statutory and judicial mandates. If the salesman who authored the coercive message at issue was, in fact, disciplined as claimed by Western Union's witness, that salesman was singled out as a scapegoat for actions consistent with overall Western Union policy during the 1979-80 timeframe.

Western Union Domestic Dominancy

The FCC has recently found that Western Union remains dominant in the "public switched record submarket" (84 F.C.C. 2d 445,515). According to the FCC, "WU's Telex/TWX network, extensive as it currently is, obviously gives it a substantial advantage over potential competitors. We believe the lack of direct substitutes for Telex/TWX confers market power on WU" (85 F.C.C. 2d 1, 25). In making these findings, the FCC rejected Western Union's attempt to escape regulation. The rejected Western Union arguments were identical to those presented to this Committee by the Western Union witness (Tr. 116-118).

Senator SPECTER. Mr. Murphy, we would be pleased to hear your testimony. We have received your written statement. It will be made part of the record. We would appreciate it if you would summarize in order to leave the maximum amount of time for questions.

STATEMENT OF EUGENE MURPHY, CHAIRMAN OF THE BOARD, RCA GLOBAL COMMUNICATIONS, INC.

Mr. MURPHY. Thank you, Mr. Chairman.

My name is Eugene Murphy. I am chairman of RCA Global Communications, Inc., a common carrier of international record communications services for more than 60 years. I very much appreciate the opportunity to be heard today.

As suggested, I will summarize our views and I appreciate that my complete statement will be included in the record.

Unlike other segments of the communications industry, international record communication services have been provided in a highly competitive market environment. Indeed, competition in international record communications has become increasingly keen. Five companies presently compete actively with a full range of record communication services. At least 10 other companies are now authorized by the FCC, or have applications pending, to provide specialized record communications in the international market. These companies are identified in my full testimony.

Senator Laxalt said on the Senate floor last week that as Government moves toward substituting competition for regulation, it must at the same time make certain that competition will replace regulation in an orderly and responsible fashion to assure its viability and vitality.

We are here in the hope that this committee will recognize and take steps to deal with the unique ability of entities that maintain monopoly market power to use that power unfairly.

Although A.T. & T. and Comsat also wield substantial monopoly power, in light of recent developments I will concentrate this morning on the threat to fair competition posed by Western Union.

Repeal of section 222 of the Communications Act without appropriate pro-competitive safeguards will benefit Western Union alone, and no other company, at the expense of the international record carriers and their 5,000 employees.

Congress enacted section 222 because it had granted Western Union a monopoly of the domestic telegraph market. That monopoly still exists today.

The FCC said in January of this year:

> The public switched record submarket consists almost entirely of Western Union's telex/TWX service. Since AT&T discontinued TWX service in 1971 and sold some of the associated facilities to Western Union, Western Union has maintained virtually a 100 percent share of this market.

That is an exact quote from an FCC docket January of this year.

Because of Western Union's monopoly, users in most of America have been forced to go to Western Union for international as well as domestic telex services. Customers with telex machines connected to Western Union's monopoly system now supply over half of all telex traffic handled by the international carriers.

Western Union is, thus, different from an ordinary competitor seeking to enter a new market. Due to its long-standing monopoly, customers generating half the international telex business are already connected to the Western Union network. Western Union has forecast to the FCC that within 3 years it will obtain the equivalent of 40 percent of the international business. That is a larger share than any international carrier now has today.

This is clearly not a typical competitive situation. Rather, it is the type of market takeover that could only occur from Western Union's exploitation of its domestic monopoly.

The main thread to the trend toward increased competitive opportunity in international communications is the power of monopoly-based entities to use their advantages to thwart competition by others. It would be ironic, indeed, if monopoly-based interests are allowed under the guise of competition to enter and ultimately dominate an already competitive market.

Although the FCC granted a limited expansion of international carrier operations a year ago, we are far from approaching competitive equality with Western Union. Thus, we are still barred by the FCC from providing domestic telex service. We are restricted to international service and only from a limited number of American cities.

On the other hand, Western Union has its nationwide monopoly domestic telex network and, through interconnection with the international carriers, also has available a nationwide overseas telex service. The domestic telex and TWX network of Western Union has 140,000 subscribers. That is more than 15 times the number of subscribers connected to any single international carrier.

Furthermore, Western Union has shown that it will not hesitate to use its domestic monopoly power to stifle competition. Western Union has refused to provide interconnection facilities to other carriers. It has sought to charge other common carriers on a basis that would make their services noncompetitive. It has overcharged other carriers for facilities and usage. Indeed, Western Union has itself acknowledged in a recently disclosed study that it earns twice as much on the services it provides other carriers as it does on the services to the public.

Senator SPECTER. Is there any remedy available for that situation which as you say is disclosed by their own admission?

Mr. MURPHY. Yes, sir. We are presently involved in a hearing before the Federal Communications Commission where this information has come forth.

Senator SPECTER. What was the form of that admission, Mr. Murphy?

Mr. MURPHY. This came in the form of some studies which were produced during the course of the hearing by Western Union. They were internal studies of Western Union.

Senator SPECTER. They were disclosed in FCC proceedings?

Mr. MURPHY. Yes, sir; at the request of other carriers who are parties to the proceeding.

Senator SPECTER. And your suggestion is that disparity in cost charges is illegal?

Mr. MURPHY. Certainly I think it is. Clearly it does not place the international carriers in a position where they could fairly compete with Western Union in trying to provide service to those very customers.

Senator **Specter**. Thank you. Proceed, please.

Mr. **Murphy**. Potential losses which Western Union could inflict must also be evaluated in the light of other proposals to permit entry by A.T. & T. and Comsat into the international record market. A.T. & T. and Comsat entry would accentuate the need for procompetitive safeguards presented by Western Union entry alone.

If the Congress is to repeal section 222, then it should take active and meaningful precautions to assure that a change will not result in anticompetitive consequences. The approach taken by Senate bill 1159 in substance would provide the necessary safeguards by linking Western Union's expansion to its domestic dominance.

The potential for anticompetitive consequences involved in a repeal of section 222 can also be curbed by legislation that would, one, assure that the FCC grants the international record carriers immediate domestic operating authority; two, would provide for full and fair interconnection with Western Union on terms that will permit meaningful competition; and, three, provide for at least a 3-year transition period that would afford the international carriers an opportunity to overcome the headstart given Western Union by virtue of its 38-year monopoly.

During this period of time we would have the opportunity to establish our own domestic network and to develop a customer base so that we could compete on a fair and equal basis with Western Union.

Thank you very much.

Senator **Specter**. Do you think during the course of such a 3-year period you could make a significant inroad on a domestic base?

Mr. **Murphy**. We think we could make a significant inroad assuming we have interconnection on a meaningful basis and where we are not in a position where through the charges to us by Western Union we cannot successfully compete. Along with that we need to have appropriate interconnection.

We think that 3 years is a minimum period, given the fact Western Union has had a 38-year headstart in its domestic monopoly.

Senator **Specter**. Thank you very much, Mr. Murphy.

Mr. **Murphy**. Thank you, sir.

Senator **Specter**. Senator Grassley, do you have questions?

Senator **Grassley**. Mr. Chairman, I have no questions at this point. Thank you.

Senator **Specter**. Thank you very much, Mr. Murphy. We may be submitting questions for the record to you, as well.

We very much appreciate your coming, gentlemen, and providing this very helpful testimony.

[Material follows:]

TESTIMONY OF GEORGE F. KNAPP
VICE PRESIDENT OF INTERNATIONAL TELEPHONE AND TELEGRAPH CORPORATION

Mr. Chairman, as an ITT Vice President and Group Executive of its Communications Operating Companies, I represent ITT World Communications, a leading international record carrier (IRC) of which I am also Chairman of the Board. ITT Worldcom provides high quality, cost effective telex, message, facsimile, data, TV and private line services (record services) to approximately 200 foreign countries. It vigorously competes with four other IRCs and several resellers in the international market.

ITT supports your request for referral of S.271 and S.898 and appreciates your efforts through these hearings to shed some light on monopoly/competitive issues which are sometimes ignored by those who would reshape telecommunications policy in a simplistic fashion. I hope what I have to say will help you in fullfilling your responsibility to advise the Senate on the monopoly/antitrust implications of telecommunications legislation especially as they relate to S.1159 and S.271.

As I testified before the Communications Subcommittee on S.271 in February, I did not think Congress would intend to allow monopolists like Western Union, AT&T, Comsat or even the Postal Service, either singly or in combination, to unfairly dominate--either through sheer market power or through control of bottleneck facilities--competitive markets which they might enter. ITT supports changing telecommunications policy to foster competition rather then monopoly. However, because of the interrelated nature of all telecommunications markets, we see no way to deal with such change without first deciding under what conditions the existing holder of a government granted or fostered monopoly should be allowed to enter competitive markets. Your introduction of S.1159 indicates that you too are concerned about monopoly domination.

BACKGROUND

During the past few years several proposals have been made in Congress to change the way communications are provided in international and domestic markets. Such proposals have varied and included comprehensive bills that would restructure the entire telecommunications industry such as S.611, bills that would treat only domestic regulations such as H.R.6121, and "one-liners" that would repeal Section 222 of the Communications Act. Of the many proposals, only one has passed--the Act was amended in the "lame-duck" session last year to make Hawaii a domestic point rather than international, a non-controversial issue.

The Federal Communications Commission has also attempted to implement policy changes on its own. It has had mixed success due to the complexity of the issues and the fact that most regulation of international communications is covered by the same provisions that cover domestic communications.

Section 222 contains special provisions in the international field which preclude some FCC actions. Therefore, efforts have been made in the past, and are presently being made again, through S.271, to repeal Section 222 by itself without regard to other pertinent issues.

Section 222 was added to the Act in 1943 to permit the merger of Western Union Telegraph and the Postal Telegraph Company. It prohibited the merged company, Western Union (WU), from providing international telegraph services except through international record carriers among whom message traffic must be divided by an equitable formula. This was done to prevent Western Union from exercising its monopoly market power in the international arena. Notwithstanding this clear legislative intent, it took 22 years of protracted legal wrangling before Western Union grudgingly divested itself of its international facilities. Over the years, both the Federal Communications Commission and the courts have interpreted Section 222 as a bar to Western Union provision of international services. Also, as a matter of FCC policy, Western Union was permitted to develop an effective monopoly of domestic telegraph services because international carriers were restricted to furnishing international services directly to customers within a limited number of specified cities, originally New York, Washington and San Francisco. Thus, while many of Western Union's services, such as its domestic satellite service, are now subject to competition, it still retains a virtual monopoly in domestic telex/TWX; telex is the major service in the international record communications market.

During the last year, the FCC granted a limited expansion of "gateways" to the international carriers and also decided Western Union could continue to provide international services through Canada and Mexico or by special arrangements with one international carrier. (Western Union initiated such international services without FCC approval or the filing of legally required tariffs.) The FCC also decided that domestic common carriers could provide domestic record services. In August, 1980, the Court reversed the FCC's interpretation of Section 222 as it pertained to Western Union thus reaffirming the legal prohibition against the direct provision of international record services by that company.

These FCC actions plus Western Union's intensive campaign have built up increasing pressure to repeal Section 222, or go around it, by fair means or foul. My testimony on the need to make it fair was ignored by the Commerce Committee. The principal reason attempts to revise telecommunications policy have failed over the years is that the monopoly/competition issues have not been adequately faced up-front.

To put the picture in perspective:

- Western Union has a customer base with about 136,500 teleprinter terminals throughout the United States connected to its own network which provides domestic services such as telex as a virtual monopoly. It handles about 700 million minutes of telex/TWX a year.

- ITT Worldcom and the four other IRCs are prohibited by FCC policy from providing domestic telex services.

- Western Union, through its network handles about half of the domestic portion of international telex traffic by connecting with the IRCs at "gateway" locations.

- The five competing IRCs provide international services directly from "direct serving cities" or "gateways." Other international message and telex services rely on interconnection with Western Union. The overseas facilities of the IRCs are owned in partnership with foreign administrations which have domestic monopoly networks at their end. Western Union is already connected to most of the customers for both domestic and international services, the IRCs are not. Nor do the IRCs have domestic networks whereas Western Union needs only to lease circuits to another country to offer complete domestic and interntional service.

THE BASIC PROBLEMS

There are three basic problems associated with the repeal of Section 222 which are compounded by Western Union's negative attitude toward the introduction of competition into its monopoly markets. One has to do with the Western Union, Government-sanctioned, monopoly position in the domestic telex/TWX market. Another has to do with the nature of foreign agreements which make international services possible. The third has to do with the FCC's unwillingness or inability to deal promptly and effectively with the facts of monopoly domination.

Western Union's monopoly position in domestic services has allowed it over the years to establish a customer base of teleprinters (connected directly to Western Union's switches) which allows it to control about half of the total international telex market. Because the IRCs do not have "effective" interconnection to Western Union's domestic system and do not have FCC authorizations to provide unlimited domestic services, the international record carriers could not provide effective competition to Western Union if Section 222 were repealed today, and Western Union authorized to provide international record service, because the IRC's could not deal with a large portion of the prospective customers. (Please also note that authorization to provide intrastate services is not within the jurisdiction of the FCC.)

Because most foreign telecommunications systems are governmental or quasi-governmental monopolies, no international service can be provided except in partnership with a foreign administration which usually must follow its government's policy. In many cases, this policy includes interconnection with the fewest number of U.S. carriers possible and the use of international revenues to subsidize other national services.

Despite our Government's pro-competitive telecommunications policy, many, if not most, of the foreign administrations would like nothing better than to sign operating agreements with Western Union in the hopes that this monopolist would eventually reduce the number of carriers seeking interconnection. Some might look forward to the day when prices for international services could more easily be kept high for lack of competition.

Throughout the debate over the repeal of Section 222 during the last few years there seems to be a myopia on the part of some, notably the FCC and some members of the Commerce Committee, that does not allow them to recognize that Western Union does in fact dominate the domestic record market (Telex/TWX) and could use this special advantage to dominate the international telex market if allowed entry via S.271. I am not sure what causes this myopia, which I like to refer to as a Western Union blind spot, but it goes to the heart of the problem, which is dominance.

DOMINANCE--THE HEART OF THE PROBLEM

In debate last week on whether S.271 should be referred to this Committee, one Senator opposing referral stated Western Union was "no longer even a monopoly in the United States." Another prominent Senator categorically stated that "Western Union no longer has a monopoly in the domestic market." If these statements were intended to refer to Western Union's general position in the entire telecommunications market, they may be accurate. However, that is not the issue. The issue is whether Western Union has dominance in the domestic public switched record services market consisting almost entirely of TWX and Telex service which the Commission has recognized as a separate and distinct submarket in its Competitive Carrier Rulemaking. As the Commission stated in the First Report and Order in that proceeding, it "proposed to classify Western Union (WU) as a dominant carrier because of its virtual de facto monopoly of Telex/TWX service." 85 FCC2d 1, 24 (1981). The Commission also observed that Western Union's attempted selection of "a business communications market as the relevant market" was "too broad." It, therefore, concluded:

> "The public switched record submarket consists almost entirely of Western Union's Telex/TWX service. Since AT&T discontinued TWX service in 1971 and sold some of the associated facilities to Western Union, Western Union has maintained virtually a 100 percent share of this market. Recent entry by Graphnet into the market has had no noticeable effect on Western Union's performance." Deregulation of Telecommunications Services 84 FCC2d 445, 515 (1981).

The determination of the FCC in its Domestic Deregulation Inquiry is consistent with that made last year by the U.S. Court of Appeals (2d Cir.). This Court stated in barring a patently illegal attempt by Western Union to finesse Section 222 by providing international telex service via Canada and Mexico that Western Union's "dominance" in the domestic market "still exists."

As recently as January of 1981, the FCC stated that Western Union "'has solidified its position for more than 35 years as a de facto monopoly'•(Graphnet, Inc. FCC 80-789, para. 24, released January 7, 1981)."

As the FCC succinctly stated in the Competitive Carrier Rulemaking "WU's Telex/TWX network, extensive as it currently is, obviously gives it a substantial advantage over potential competitors. We believe the lack of direct substitutes for Telex/TWX confers market power on WU." 85 FCC2d, 25 (1981).

ITT Worldcom submits that this Committee, charged with the responsibility for antitrust oversight, must consider the conclusions of the responsible regulatory agency, in proceedings based on the record, as to whether switched record services constitute a distinct and relevant submarket and whether Western Union is dominant in that submarket.

The existence of factual myopia regarding the question of Western Union dominance by supporters of S.271 makes passage of S.1159 introduced by the Chairman of this Committee and cosponsored by a number of its members imperative. Since the Western Union Telex and TWX services, forming part of the switched record communications submarket, are clearly "tariffed services," Western Union's dominance in the relevant submarket would bring it within the scope of this proposed amendment to the Clayton Act. This is only fair since if Western Union is still "dominant," then precisely the stated policy considerations which impelled Congress to enact Section 222 of the Communications Act in the first place are as germane today as they were in 1943.

As and when Western Union has ceased to be dominant in the relevant submarket, the proposed amendment to Section 10 of the Clayton Act will no longer be applicable to that company and assuming S.271 were passed, there would no longer be any statutory bar to the authorization of Western Union to provide international switched record services. But this is a question of fact. The possibility of future Western Union non-dominance was clearly contemplated by the FCC in the Competitive Carrier Rulemaking when it stated:

> "While we agree that the future is likely to see major changes in the relevant markets in which WU now operates, for the reasons explained above, we do not believe that the substitutes available in the marketplace are as yet having a sufficient restraining effect on WU's pricing and marketing conduct to justify a finding of non-dominance at this time." 85 FCC2d at 25.

The potential abuses by Western Union of its monopoly position are not imaginary; they are very real. I attached to my February, 1981 Testimony before the Communications Subcommittee of the Committee on Commerce, Science, and Transportation a telex message which was distributed by Western Union to its customers at the time Western Union was providing illegal telex service to overseas points via Canada and Mexico. That telex message, which graphically demonstrates the manner in which Western Union can and would abuse its domestic monopoly position, stated that "beginning July 1 Western Union repair personnel will give 'special priority' to any telex or

TWX machine needing attention 'if that machine is used to send overseas messages via Western Union's international telex service.'" And "those that do not utilize the service will be placed at the bottom of the call order no matter when the repair order was placed." To make sure that its customers did not miss the point, the Western Union message continued, "Even if an overseas customer orders repairs after you, you will be called on after him. This could delay your repairs for days."

Another demonstration of the manner in which Western Union can be expected to misuse its monopoly power was recently brought to light in CC Docket No. 78-97, which is a proceeding to determine the lawfulness of charges established by Western Union for Telex and TWX services provided to the IRCs and other domestic subscribers.

From the inception of this case, the IRCs contended that the Telex and TWX interconnection services provided to them by Western Union cost Western Union substantially less than the cost of providing similar services to the public, and that, therefore, Western Union's charges to the IRCs should be substantially less than its corresponding charges to the general public.

Western Union has repeatedly and vigorously denied knowledge of any meaningful cost differences in providing Telex and TWX services to the IRCs. Nevertheless, some three years into the course of this proceeding, it was revealed that, at least since December of 1977, and probably before that, Western Union has been in possession of evidence which it did not furnish though asked to do so in discovery that unmistakably supported the IRCs' claims. The evidence shows, for example, that by one of several generally similar Western Union cost calculations, Western Union's usage earnings for 1977 following a classic monopolistic pattern were as follows:

	Intrastate	Interstate	IRC
Telex Rates of Return	0.5%	10.3%	27.2%
TWX Rates of Return	0.5%	63.6%	150.7%

And, in at least one provable instance discovered so far, Western Union provided information to a state agency that could demonstrate these dramatically disparate earnings between the three categories of service.

It seems obvious that Western Union, a domestic monopoly, deliberately structured its rates so as to receive an artificially low rate of return from intrastate service where it faced potential competition and artificially high rates of return from the provision of service to the IRCs who had no alternative but to utilize Western Union's services to reach "hinterland" users.

Another graphic example of Western Union's misuse of its monopoly power has been in the matter of refusal to grant the IRCs full and fair interconnection with its nationwide domestic network. In 1976 after the FCC authorized a limited expansion of IRC gateways, interconnection at these points was requested from Western Union. On July 11, 1980, some four years later, the FCC ordered Western Union to interconnect at these additional gateways. Western Union has consistently and successfully "stonewalled" all efforts by the Commission and the IRCs to obtain the desired interconnection and to this date it has not been accomplished.

THE REALITY OF COMPETITION

The revamping of the 1934 Act, or even the repeal of Section 222, to promote competition in changing international markets might have surface appeal to some members of Congress as did the rejected "Bell Bill" of a few years ago. But if the reality of the situation is carefully examined, any necessary changes will undoubtedly be made in conjunction with an overall revision that affects all communications markets. For in reality, competition already exists and piecemeal change is more apt to destroy it than expand it in both domestic and international markets.

It is instructive to look at the development of the international record market, where competition has reigned since the development of international radio facilities in the early 1900s. After all, the result of repealing Section 222 by itself as proposed in S.271 would be to remove the bar to Western Union expansion of monopoly services internationally without allowing reciprocal expansion by the IRCs.

With varying fortunes over the years, the five IRC's (ITT, RCA, WUI, TRT and FTCC) have struggled against each other for share of market using quality, new services, features and price. (Some people argue that the IRC's are not price competitive because their charges for some services are the same to a given country. Actually that proves the point - when one cuts the price, the others must match to keep their market shares.) From the days not too long ago (the early 1950s) when the only way to send or receive an international record message over not always reliable radio circuits at a high price , the competitive battle among the IRC's has created a market which offers not only low cost, reliable telex service ($1.43 per minute to London) over satellite or underseas cable but even lower cost data services like ITT's UDTS to many parts of the world. In addition, each IRC vies to offer various special features such as store-and-forward and abbreviated dialing which substantially improve customer efficiency. Today the consumer has many high quality, declining cost alternatives for international service. Just since 1960 the cost of a telex minute to London has dropped by 52 percent (82 percent if adjusted for inflation) because of competition and technological improvements. Attachment A shows the decrease in telex rates to several points in both current and constant dollars.

Another example of how intense the competition is among the IRCs is provided by looking at the change in market shares over the years. Attachment A shows, for instance, that RCA has gone from a dominant position in 1960 (70 percent) to 33 percent in 1980, while TRT with almost no market share, has increased to 7 percent.

CONDITIONS NECESSARY TO FOSTER EFFECTIVE COMPETITION

The best way to make sure truly effective competition continues in the international market is to exclude Western Union, as long as it maintains a monopoly in the relevant switched record service submarket. In effect, S.1159 would accomplish this. However, there are specific conditions which would help ensure a fair competitive market when Western Union does enter the international arena.

1. Western Union must provide effective, non-discriminatory and reasonably priced interconnection to the international record carriers.

"Effective" means that Western Union interconnects with the IRC's with a sufficient number of trunks in the appropriate locations so that users would enjoy the same quality of service for international traffic via an IRC as via Western Union. Western Union has a long history of maintaining its bottleneck monopoly by refusing to interconnect at all with would-be competitors or interconnecting in such a limited manner that the would-be competitor cannot offer a viable service.

"Non-discriminatory" means that a subscriber on the Western Union network follows exactly the same procedures and selects the same number of digits when placing an international call via an IRC as when placing an international call via Western Union. This also means that the subscriber, not Western Union, must have the ability to decide which carrier will handle each international call.

"Reasonably priced" interconnection is obviously required if the IRC's are expected to be able to compete with Western Union on anything like a fair and equitable basis. Western Union exploits its monopoly control over significant volumes of traffic by high priced interconnection.

2. The IRC's must be authorized to provide domestic services by elimination of the "gateway" concept.

If the purpose of S.271 is to bring the benefits of additional competition to users of record/data communications service, the competition must be implemented across the board. Indeed, it is certain that consumers will benefit much more from the introduction of competition in the monopolized domestic market than they will from any additional competition in the already highly competitive international record/data market.

3. There must be provision for reasonable transition to truly effective competition in the domestic telex market.

Effective competition in the domestic telex market might help prevent Western Union from extending its monopoly into the international market. In the Domestic Deregulation Inquiry, the FCC confirmed its proposal to classify Western

Union as a dominant carrier. "...because of its virtual de facto monopoly of telex/TWX service."

There is some speculation that a moratorium of some fixed period might be a way to prevent Western Union from exploiting its domestic monopoly. However, it is not certain how long it would take for the IRCs to build a customer base and put together networks.

We do not believe that the FCC will find that effective competition exists in the domestic telex market before it grants Western Union authority to enter the international telex market. If the FCC were to do so using standards similar to those developed under antitrust procedures and assured itself that reasonable interconnection was being provided at the same time, it might help. However, there is no reason to believe it would do so because the FCC seems to be ready to ignore its own findings of Western Union dominance in domestic Telex/TWX and let it enter the market without restraint as the FCC testified at the recent S.271 hearing. S.1159 would send a Congressional message to the FCC that such findings are necessary.

4. An equitable distribution of unrouted traffic is needed during transition.

Under Section 222, unrouted message traffic which comes from Western Union customers must be equitably distributed among the IRCs according to a formula. Without this provision, Western Union would have it all until such time as effective competition is established.

5. Jurisdiction over intrastate record services must be shifted to the FCC to facilitiate domestic competition.

Without a shift in jurisdiction, the IRCs would have to apply in each state in order to provide intrastate and intercity services competition among cities within a state (Los Angeles to San Francisco for instance). This could be a long involved process which would be used by Western Union to protect its monopoly.

Most of these problems were acknowledged in the report issued by the Commerce Committee on S.271. However, it concluded that the FCC had the authority to solve such problems and, therefore, it was not necessary to address them in the legislation. It has been repeatedly demonstrated that Western Union is prone to exploit its monopoly position, and our experience is that the FCC has been reluctant to use its powers to stop it. I have attached a letter from ITT Worldcom's General Counsel, Howard A. White, to then Acting Chairman Lee which points this out and comments on other aspects of the Commission's testimony before the Communications Subcommittee.

CONCLUSION

In conclusion, my major points are:

1. Western Union's entry into the international market, as long as it retains its domestic

telex/TWX monopoly, will not foster competition.

2. Western Union does enjoy a virtual monopoly in domestic telex/TWX.
3. The Western Union problem is no different than the entry of any monopolist into a competitive market and must be solved prior to allowing such entry, a principle that would apply to S.898 as well.
4. Western Union has demonstrated a pattern of anticompetitive behavior that justifies ITT's concern over its entry.
5. The passage of S.1159 would help ensure that effective competition would continue in the international record market.
6. There are a few specific conditions that should be added to S.1159 and/or S.271 in order to preserve effective competition when Western Union is allowed to go overseas.

I would again like to thank you for bringing monopoly/competition issues to the attention of your colleagues in the Senate and I would be happy to cooperate with this Committee and its Staff in its efforts to overcome the special efforts being made on behalf of Western Union or any other entity enjoying monopoly advantages.

TESTIMONY OF GEORGE F. KNAPP ATTACHMENT A

COMPETITION IN THE TELEX MARKET

INTERNATIONAL TELEX MARKET SHARES

	1960	1965	1970	1975	1980
ITT	30%	35%	39%	39%	35%
RCA	70%	52%	36%	37%	33%
WUI	-	13%	23%	21%	24%
TRT/FTCC	-	-	1%	3%	8%

INTERNATIONAL TELEX RATE CHANGES ($ PER MINUTE)

	1960	1980		
	RATE	RATE	% DECREASE	
			Current	Constant*
US/Germany	$3.00	$1.94	35%	75%
US/UK	3.00	1.43	52%	82%
US/Brazil	3.00	2.33	22%	70%
US/Hawaii	2.00	1.15	43%	78%
US/Japan	3.00	2.23	26%	71%

*GNP Price Deflator

ATTACHMENT B

ITT World Communications Inc.

Howard A. White
Senior Vice President and
General Counsel

67 Broad Street
New York, N.Y. 10004
Telephone (212) 797-4825

March 4, 1981

The Honorable Robert E. Lee
Acting Chairman
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Re: S. 271, a Bill to Repeal Section 222 of the Communications Act

Dear Chairman Lee:

Recently, testimony relating to S. 271 was submitted in your name, on behalf of the Commission, to the Senate Subcommittee on Communications. That presentation "unequivocally" supported repeal of Section 222. Commissioner Jones' oral testimony before that Subcommittee on February 18, 1981 was to the same effect. We are taking the unusual step of challenging the validity of that testimony because it does not present the pertinent facts and circumstances in a full and fair manner.

Of course, we disagree with the conclusions of the Commission relating to Section 222. But we are most troubled by the Commission's extreme advocacy in this matter. And, since it is likely that the Congress will assume that the FCC is impartial, the apparent decision to present only those facts or arguments which support the Commission's conclusions compounds the unfairness of such advocacy.

Despite the failure of the Commission to seek current public comments on the benefits and/or detriments of Section 222, it has concluded that that section is an "anachronism." To reach that conclusion, "facts" have been taken out of context and other relevant points -- even Commission findings -- have been omitted. Some of those distortions and omissions are hereafter noted.

The Commission properly takes credit for the authorization of new competitors in the international record communications market. Today, in addition to ITT Worldcom, RCA Globcom and WUI, the leading providers of international record services, new and formerly limited competitors, including TRT, FTCC, GTE Telenet, Graphnet, CCI and IRI, have been authorized to provide a broad range of competitive services. As a matter of fact, the new and expanding carriers (plus a few illegal operators) are already winning a significant share of the total market. In the circumstances, it is difficult to understand why those carriers, and other potential entrants, are not sufficient to develop the kind of competition the Commission seeks, without the entry of Western Union. On the one hand, it is alleged that the Commission has fostered competition through its authorization and support of new carriers and new services; on the other hand, it is now argued before the Senate Subcommittee that competition in the IRC industry will not be a reality until a single additional carrier, namely Western Union, is permitted to join the fray.

The arguments made by the Commission, in support of S. 271 -- a bill which we have characterized as special interest legislation -- rest on two assumptions, to wit: some competition has been introduced in what may be broadly defined as the domestic record market; and certain inconclusive data suggest that the IRCs have, in recent years, achieved good rates of return for their international telex services. By omitting consideration of Western Union's dominance over domestic telex/TWX and telegraph message services, or of Western Union's ability to extend that market dominance if it is permitted to provide those services internationally, the Commission seems to favor Western Union's entry into the international field as a means of compensating that company for the potentially adverse effects of domestic competition and/or punishing the IRCs for their successful offerings of international telex.

Other supporting statements need correction or completion. For example, the Commission's "international audit" of IRC operations in 1976 is cited for the purpose of showing that pre-tax earnings on international telex services were high. Clearly, the use of pre-tax returns, instead of after-tax returns, was designed to evoke emotional responses. A fair presentation of the relevant percentages would indicate that even when telex is considered alone, the returns received by the IRCs, pre-tax or after-tax, are well within the range of those achieved by successful, unregulated competitive businesses in the United States. (Presumably, the FCC is working toward less regulation of competitive telecommunications services.) At the very least, the Commission should have reported its own recent conclusions regarding the earnings of the IRCs. In a Memorandum Opinion and Order (FCC-8586), released November 14, 1980, instituting an investigation of ITT Worldcom's overall rate of return, the Commission concluded that ITT Worldcom, allegedly the most efficient IRC, achieved an overall 15% rate of return after taxes -- using the same Audit Report in Docket No. 20778 from which high pre-tax telex returns were cited to the Senate Subcommittee.

In the development of its argument that circumstances have changed since 1943, when Section 222 was enacted, the testimony notes that "traditional telegraph service has declined substantially," but fails to note that Western Union still dominates that service. Instead, the FCC emphasizes the new competition faced by Western Union, without recognizing the nature and extent of the competition applicable to each service.

Another example of unfairness in the Commission's presentation to the Subcommittee is the contention that the approval of additional IRC points of operation in the United States -- where the IRCs have access to customers for the handling of international traffic only -- and the pending applications of certain IRCs for authority to provide limited domestic record services lead to the conclusion that "Western Union's market position is being weakened." Nowhere in the testimony does the Commission deal with the great disparity between the number of telex/TWX customers connected directly to Western Union's network and those connected directly to the networks of the IRCs. If Western Union's monopoly telex position has been weakened to any extent, certainly the damage is not large enough to make it difficult for that carrier to propose postalized rates which would preclude domestic telex competition for the foreseeable future.

The FCC has concluded that "section 222 not only serves to bar Western Union entry overseas, it also serves as a basis for legal actions jeopardizing domestic entry by the IRCs." Since the issue has been fully litigated, it can not be seriously argued that the repeal of Section 222 will result in less litigation; most often, new legislation tends to create fertile ground for additional litigation.

The Commission also argues that

> "As domestic competition has expanded, any domestic market power Western Union might have had has been eroded, and it is likely to continue to dissipate. It is thus unlikely that Western Union has untapped monopoly profits to draw from to finance predatory behavior in the international record market."

Surely, the FCC does not really believe that high profits are necessary to engage in anticompetitive behavior. Western Union has disproved that theory many times over. (Please see the attached copy of the testimony of Mr. George F. Knapp, ITT Worldcom's Chairman, submitted to the Subcommittee on February 18, 1981.)

In expressing its frustration over efforts to administratively revoke Section 222, the Commission refers to to recent Court decisions. Unfortunately, the Commission unduly narrowed its interpretation of the findings of the Second Circuit by stating, "[the Second Circuit] recognized the many fundamental changes in the domestic markets, particularly the entry of competitors to Western Union, that supported the Commission's policy." In our view, that statement is a misrepresentation of a clear finding of the Court that

> "It may be that these factors warrant a revision of S222 to suit the changes in the market, most of which were approved by the Commission itself. But the plain language of S222, its history, and the interpretations of it by the courts and the Commission, make it clear that in order to protect the IRCs against abuse by WU of its dominance of the domestic market (which dominance still exists) it is not entitled to engage in international telegraph operations." (emphasis added)

Finally, the Congress is asked to trust the Commission to utilize its available power in a manner that will ensure reasonable and fair competition if Western Union is permitted to provide international record services. Although we recognize that such powers are available to the Commission, our experience has been that when Western Union was involved the Commission has been reluctant to use them. Obviously, such powers were available to the Commission when it ignored earlier Court and FCC decisions by refusing to order discontinuance of Western Union's international services without benefit of tariff (notwithstanding the Commission's determination that such a tariff was required) or appropriate Section 214 authority, by failing to impose any conditions on Western Union which would have assured unbundled, cost-effective, non-discriminatory interconnection with the IRCs, and by failing to consider the other anticompetitive aspects of such entry. Indeed, the Commission demonstrated that it was only interested in promoting Western Union's entry into the international record market, and paid no attention to its bottleneck- monopoly position and market power.

We doubt that any new "facts" have come to the FCC's attention since the release, on November 28, 1980, of its First Report and Order (FCC 80-629) in CC Docket No. 79-252, concerning the proposed deregulation of certain carriers, wherein it was concluded (in paragraph No. 71) that

> "While we agree that the future is likely to see changes in the relevant markets in which WU now operates, for the reasons explained above, we do not believe that the substitutes available in the marketplace are as yet having a sufficient restraining effect on WU's pricing and marketing conduct to justify a finding of non-dominance at this time." (emphasis added)

In short, Mr. Chairman, we believe it is time for the Commission to carefully review all of the relevant circumstances and to assure itself and the Congress that it is relying on full and fair reports of pertinent facts and issues.

Sincerely,

TESTIMONY OF ROBERT E. CONN
WESTERN UNION INTERNATIONAL, INC. (WUI)
BEFORE THE SENATE COMMITTEE ON THE JUDICIARY

Mr. Chairman and members of the Committee, I am Robert E. Conn, Executive Vice President of Western Union International, Inc. (WUI), one of the major international record carriers.* I have been involved in telecommunications for more than 25 years in both the government and private sectors.

I. SUMMARY

A. Entry of The Domestic Telegraph, Monopoly Carrier Into the Competitive International Record Carrier Market, Without Procompetitive Safeguards, Will Be Destructive of Competition In This International Market. As a result of governmental actions over the years, Western Union substantially controls the public's access to the international record carriers (IRCs). Consequently, Western Union is capable of diverting about half of the business of the IRCs once Western Union enters the international record carrier market. Congress wisely barred such market entry many years ago, and has not repealed this constraint despite massive and prolonged efforts by Western Union to gain repeal of the statutory bar. Western Union's domestic dominance was bestowed upon it by the Government, which also nurtured and protected that dominance for nearly 40 years. Therefore, Congress will not be writing on a clean slate if it enacts new legislation authorizing a further expansion of Western Union's scope of operations.

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* WUI is not affiliated with the domestic Western Union Telegraph Company (Western Union) despite the similarity in names. Western Union is sometimes referred to in this testimony as "the domestic telegraph, monopoly carrier."

B. Minimal Procompetitive Safeguards Would Be Essential If The Dominant Western Union Were To Enter The International Market.

1. Transition Period. A reasonable transition period is essential to accord the international record carriers an opportunity to expand and develop their previously restricted scope of operations in order to withstand the onslaught of international market entry by the domestic telegraph, monopoly carrier. Any abrupt "flash cut" permitting immediate market entry by Western Union would enable it to extend its domestic dominance into the international market and substantially to lessen competition in that market.

2. Interconnection And Public Access. Western Union controls "bottleneck" facilities which constrict the flow of about half of the total volume of U.S. international telex messages. Any new legislation should mandate that Western Union provide both fair and nondiscriminatory interconnection with the respective telex networks of each international record carrier. The public throughout the U.S. must have access to the IRC of its choice, unimpeded by Western Union which now occupies the position of a "gatekeeper." During the 1979-1980 timeframe when Western Union unlawfully operated in the international telex market, the domestic monopolist demonstrated how it could manipulate its "gatekeeper" role to divert international telex messages to a combination of its own unlawful international route and preferentially to a single IRC which was willing to "cooperate" in promoting Western Union's unlawful international market entry.

3. Equitable And Nondiscriminatory Message Interchange. If Western Union occupied the dual roles of a dominant domestic record carrier and a competitive international record carrier, a natural tendency would exist for the company to divert overseas telegrams to its own international arm. Indeed, the dockets of the Federal Communications Commission (FCC) are replete with such conduct during the 1943-1963 timeframe when Western Union occupied such dual roles. Accordingly, any new legislation should mandate that Western Union interchange overseas telegrams with the IRCs on an equitable and nondiscriminatory basis.

4. Domestic Market Entry. Any new legislation should clearly indicate that the IRCs are not barred from entry into the domestic marketplace. Although current laws do not bar domestic market entry by the IRCs, the FCC has generally precluded such entry as a matter of policy. During the transition period, described above, the IRCs should be accorded the opportunity of unlimited domestic market entry.

C. Fragmentary Revision of The Laws Governing Competition And Monopolization In The Telecommunications Industry Can Only Lead to Uncertainty And Confusion In The Industry. The currently pending "International Record Carrier Competition Act of 1981" (S.271) would summarily repeal the existing statutory bar to Western Union's international market entry. However, that bill does not include effective procompetitive safeguards, but rather relies upon existing provisions of law which allegedly empower the FCC to impose such safeguards as a condition to any international market entry by Western Union. Paradoxically, another pending bill, "Telecommunications

Competition and Deregulation Act of 1981" (S.898), would repeal the FCC's authority to regulate Western Union's market entry.

Therefore, the combined effect of S.271 and S.898 would enable Western Union unilaterally to enter the international marketplace. Further complicating this flurry of legislative activity is a recent authoritative statement that the Senate Subcommittee on Communications will undertake a revision of the statutes governing international telecommunications later this year. Although that Subcommittee is diligently endeavoring to get its job done, some entity in the Senate must assume a coordinating role.

WUI is grateful that the Judiciary Committee is undertaking its series of hearings on the topic of monopolization and competition in the telecommunications industry. If there are to be changes in the laws governing this industry, any such changes must be accomplished in a coordinated and consistent fashion. The pendency of seemingly inconsistent legislation and the potential emergence of further relevant legislation is causing confusion and uncertainty in the industry. This result cannot be favorable for the public because the carriers must be able to plan in advance for the provision of innovative and efficient services in order to adequately meet the future needs of the public.

II. INDUSTRY STRUCTURE AND BACKGROUND

A. Present Structure of International Industry

The existing international record carrier industry is the only competitive international telecommunications industry subject to the FCC's jurisdiction. Moreover, we believe that it is the most competitive telecommunications industry now fully regulated by the FCC. The international telecommunications industry operating out of the U.S. Mainland is currently composed of:

(1) One monopoly telephone carrier -- American Telephone & Telegraph Co., with estimated annual international revenues in excess of one billion dollars.

(2) A highly competitive international record carrier industry involving at least 11 companies, none of whom have more than about a one-third share of the market:

 (a) Six competitive international record carriers who submit financial reports to the FCC -- WUI; FTC Communications, Inc.; ITT World Communications Inc.; RCA Global Communications, Inc.; TRT Telecommunications Corporation; and U.S.-Liberia Radio Co.

 (b) Five recently authorized international record carriers who do not submit international financial data to the FCC -- GTE Telenet Corporation; Graphnet, Inc.; Consortium Communications International, Inc.; International Relay, Inc.; and Unitel Corporation.

 (c) Additionally, several would-be international record carriers have applications pending before the FCC; and many psuedo-type carriers are now operating internationally from the U.S. without any lawful authority.

(3) One monopoly carrier -- Comsat -- which supplies satellite circuits to the international carriers on a wholesale basis.

The FCC is currently conducting proceedings to determine whether AT&T and Comsat should be declared eligible to enter the international record carrier market.

The international record carriers are relatively small as compared to their potential competitors. Based upon 1980 FCC-reported statistics, Western Union's annual revenues of $697 million from communications services are more than 3.7 times those of RCA Globcom -- the IRC with the highest revenues for 1980. Total 1980 revenues for the six IRCs, who submit financial reports to the FCC, were almost $535 million.

None of the IRCs has a monopoly-based communications market, as does Western Union, AT&T and Comsat. Therefore, it is important that a full and fair competitive international record market be preserved if the public is to continue to enjoy the service efficiencies and economies that have been provided by the international record carriers.

B. Western Union's Dominance In The Domestic Market

Western Union enjoys geographically-unlimited FCC authority to provide communications services throughout the continental United States. Western Union enjoys a telegraph monopoly over domestic telex/TWX and telegram services, both acquired with antitrust immunity by virtue of Section 222 of the Communications Act of 1934, as amended (47 U.S.C. §222). Telex/TWX service is a public dial-up service for the transmission of record (as distinguished from voice) communications by teleprinter machines having a typewriter-like appearance. Western Union's dominancy in the domestic telex/TWX market is enhanced by its extensive domestic satellite network (Westar) and its nationwide terrestrial network, by its emerging domestic telephone system (Metro I), and by its exclusive arrangement with the U.S. Postal Service for Mailgram service.

Earlier this year, the FCC declared that Western Union "has maintained virtually a 100% share" of the domestic telex/TWX market since its acquisition of the TWX system in 1971 under Government auspices. This monopoly by Western Union over public switched business communications constitutes a Governmentally protected bottleneck through which about half of the IRCs' international telex traffic must flow.

Western Union's domestic telex/TWX monopoly consists of about 140,000 actual and potential international telex subscribers, who can communicate with one another domestically and with telex users abroad. By contrast, none of the keenly competitive IRCs has a telex network of even 10% the size of Western Union's monopoly system. None of the international record carriers has regulatory authority to provide wholly domestic communications within its respective small network. WUI's telex network would be larger today, and more useful to the public, if it had not been subjected to regulatory restriction for the benefit of Western Union.

Western Union has a nationwide system of strategically located telex/TWX switching centers, connected by Western Union's own nationwide transmission lines.

C. International Record Carrier Operations Within The Continental United States Have Been Constrained To Protect Western Union

WUI tried throughout the decade of the 1970s to break out of its confined operations within the corporate gateway city boundaries of New York, San Francisco and Washington. We succeeded only in adding Miami and New Orleans in 1976.

The protective mantel of Government surrounded Western Union. WUI was denied the opportunity to expand its direct services to the suburban areas of its gateway cities as business and industry relocated outside of the central cores of the aging cities. In 1971, the FCC even rebuffed WUI's attempts to serve Crystal City, Virginia -- next door to Washington's National Airport -- as many of WUI's downtown Washington customers relocated to that nearby suburb. The FCC has been so protective of Western Union that -- to this day -- WUI is compelled to add a surcharge onto cablegrams filed directly by phone or telex from the hinterland of the United States so that Western Union has a rate advantage to compensate for its indirect and inferior service.

Less than one year ago -- July 14, 1980 -- WUI was authorized by the FCC to commence its direct service to 21 additional cities within the U.S. mainland and to the suburban areas surrounding each of WUI's new total of 26 operational cities. We understand that last week the FCC granted us authority to operate in 9 more cities.

One year of partial freedom from our geographical imprisonment is merely a spot in time as compared to the 38 years of Governmentally protected monopoly for Western Union. Even this mere one year was partially overlapped by a year of unlawful international service performed by Western Union. The present FCC appears willing to cease protecting Western Union. However, the existing regulatory restraints upon the IRCs' domestic operations need to be vacated before the IRCs achieve regulatory parity with Western Union.

D. Establishment of WUI

Pursuant to an Act of Congress and an implementing Order of the FCC, WUI commenced operations as an independent record carrier on September 30, 1963. Prior to 1943 there were two telegraph companies -- The Western Union Telegraph

Company (Western Union) and Postal Telegraph Company -- engaged in domestic telegraph operations. Western Union sought to acquire Postal, but legislation was necessary because a domestic telegraph monopoly would result.

After lengthy hearings, Congress enacted Section 222 of the Communications Act in 1943 permitting Western Union to acquire a monopoly position in the domestic telegraph field, provided that Western Union moved and stayed out of the international market through divestiture of its international operations. These monopoly benefits, which later afforded Western Union the further opportunity of expanding that monopoly by acquisition of the TWX system in 1971, were the *quid pro quo* for Western Union's staying out of the international market.

In 1943, Congress recognized that competition could not be maintained in the international market if the monopoly based Western Union were permitted to operate in that market. Western Union still has a strong monopoly base. As recently as January 16, 1981, the FCC stated that Western Union "has maintained virtually a 100% share" of the domestic switched telex/TWX market.

Merger was permissive; divestiture was mandatory. The permissive Western Union-Postal merger was consummated almost immediately following the enactment of Section 222. However, the FCC dockets are replete with evidence of 20 years of delay by Western Union until the divestment of its international operations to WUI in 1963. During this period, Western Union unsuccessfully lobbied before Congress for repeal of its divestiture obligation. During the 20 years that the monopoly domestic telegraph company also conducted international operations, the other international record carriers were constantly before the FCC with complaints of Western Union's favoritism of its own international arm. The FCC found serious abuses by Western Union to the competitive detriment of the other international carriers, which caused the FCC to press Western Union to divest.

As part of the divestiture in 1963, the domestic telegraph company covenanted not to compete with WUI in international telegraph operations for 25 years. This covenant and the international franchise were essential assets acquired by the new WUI. All of the divestment agreements were reviewed by the FCC during lengthy hearings, and were either approved, modified, or disallowed. The covenant-not-to-compete was approved by the FCC, and substantially relied upon thereafter by the investors in WUI securities, our stockholders and lenders.

Thus, there are two bars against international reentry by the domestic telegraph company -- statutory and contractual. Nevertheless, Western Union now wants the international market contrary to its statutory and contractual covenants.

E. Accomplishments of WUI And The International Record Carrier Industry

During the last 15 years the competitive international record carrier industry has compiled a record of rate reductions and service improvements, not mandated by Government regulatory authorities, that are unequaled in the telecommunications industry. The consumers served by our industry have enjoyed communications expense reductions during the last 15 years, while the international record carriers have been hard hit by the inflationary spiral.

1. WUI Rate Reductions. Our telex rate reductions have ranged up to 50% and there have been reductions

in the minimum billable period for telex calls. Our rate reductions for private line leased channel service have ranged up to 85%. U.S. Government agencies who are large users of our international private line service, via submarine cable and satellite, have received about $25 million in rate reductions from WUI alone. These governmental savings must have at least tripled, when measured on an international record carrier industry-wide basis. Even WUI's rates for international telegrams have remained stable, as contrasted with the domestic telegram service which has been practically priced out of the market.

2. WUI Shielded Its Customers By Absorbing Domestic Rate Increases. During the last 15 years, WUI was the buffer for its customers by absorbing $35 million of rate increases by Western Union for interconnected international telex services, and about $17 million for interconnected telegram service. Again, these communications expense savings by the consumer probably should be at least trebled to obtain an industry-wide result.

If Western Union had dominated the international market during the last 15 years, as it has domestically, we estimate conservatively that the consumers would have been paying $200 million more for their international communications.

3. Service Improvements And Innovations Have Abounded In The International Record Market. WUI and the other competitive international record carriers have utilized computer technology to spawn many public benefits well ahead of international telephony and of the domestic telegraph industry. For example, the IRCs offered overseas automatic direct dialing for telex calls before AT&T of-

fered it for overseas telephone calls. Due to the IRCs' modern computerized telex switching centers, international telex calls between the U.S. and more than 200 countries abroad can be conducted in an on-line conversational mode -- an achievement Western Union has not yet attained for the subscribers to its two separate domestic networks, telex and TWX. The respective IRCs are continuously making competitive breakthroughs in abbreviated customer dialing, customized protocols for individual customer requirements, and accelerated and detailed billing to satisfy individual customer needs.

F. Fair Competitive Market Is Essential

WUI aspires to continue to provide excellent service at the lowest reasonable rates. We are prepared to invest many more millions of dollars in the most advanced transmission facilities -- cable, satellite, fiber optics or whatever future technology develops -- and in central office computerized switching equipment. In cooperation with telecommunications entities abroad, our foreign correspondents, we are willing to continue to improve existing services and to develop new ones. However, we do need a regulatory environment in Washington committed to full and fair competition in the international sector.

We desire an opportunity to provide new and improved services in a fair, competitive market, and to interconnect with the U.S. monopoly, domestic carriers on an equitable and nondiscriminatory basis. This interconnection is necessary so that we can serve our customers in both our numerically limited direct-service gateway cities and in the vast hinterland accessible only through the domestic carriers.

As explained later in my testimony, Western Union has misused its monopoly power by refusing to interconnect with WUI in 24 of its 26 operational gateway cities. Western Union has also abused its monopoly power by according preferential interconnections and message distributions to a preferred IRC to the competitive detriment of WUI and other nonconforming IRCs. Twice in the last 5 years, Western Union has persuaded the FCC, contrary to existing law, to support Western Union's reentry into the international market. Twice the Courts have reversed. Just last September, the Court of Appeals for the Second Circuit found that Western Union's conduct has been "contemptuous."

Although the FCC has recently favored repeal of Section 222, it has also observed Western Union's intensive abuse of its monopoly powers during the last 18 months. Earlier Commissions similarly observed such abuses during the period, 1943-1963, when Western Union engaged in both domestic and international operations. Accordingly, these earlier Commissions favored retention of Section 222. Hopefully, the new administration at the FCC will approach this unique issue of monopolization and competition in the telecommunications industry with an open mind, rather than automatically adopting the position of its predecessor.

Perhaps the FCC, upon reflection, will favorably consider the need for a statutory reasonable transition period and for statutory procompetitive safeguards to preserve competition in the international market, if Section 222 were to be repealed. After all, when the FCC endorsed

S.271 four months ago, it could not have known that S.898 (introduced on April 7, 1981) would strip it of its authority under current law to regulate Western Union effectively.

III. WESTERN UNION ASPIRES TO EXTEND ITS DOMESTIC MONOPOLY INTO THE INTERNATIONAL MARKETPLACE, THEREBY SUBSTANTIALLY LESSENING INTERNATIONAL COMPETITION

Congress conducted extensive hearings and considered alternate bills before it enacted Section 222. In granting Western Union the unique right to acquire a domestic telegraph monopoly with antitrust immunity, Congress barred Western Union from the international market in reliance upon FCC testimony that:

> "It is, thus clear that the international carriers do not exaggerate when, in stating their views about domestic merger, they claim that the domestic monopoly will have the power of life or death over the unmerged international companies."

History has confirmed that the domestic telegraph monopolist will cause havoc in the competitive international sector.

A. Western Union Misused Its Domestic Monopoly To Disrupt Fair International Competition During The 1943-1963 Timeframe

Despite its obligation under Section 222(c)(2) to "exercise due diligence" in divesting its international operations, Western Union dragged its feet for 20 years. In 1952, the FCC began an investigation of Western Union's failure to divest. The FCC found that Western Union had misused its monopoly over domestic telegraph operations to take unfair advantage of the international carriers, as Congress had feared it would do. After reviewing evidence demonstrating how Western Union had diverted traffic to its own international lines that senders had expressly routed via the independent international carriers, the FCC catalogued for some 13 pages these abuses by Western Union. The FCC concluded that it must apply additional pressure upon Western Union to attain divestment because:

> "...Western Union is in the dual positions of an international participant and the initial judge of any differences of opinion which may arise as to formula interpretation. Assuming the best of faith on its part in its interpretation of the formula, Western Union cannot be regarded as an impersonal forwarder in the present conditions of conflicting interests. We think that it is manifest, from our extensive findings in this connection, that continued operation of the cables by Western Union gives rise to serious problems in the distribution of international telegraph traffic, and that such problems cannot be alleviated other than by divestment. Thus, the reasons which impelled Congress to require divestment of Western Union's telegraph operations have been amply justified by experience under a combined landline-cable operations."

During the 20-year period after it acquired its domestic telegram monopoly, Western Union sought to evade its reciprocal obligation to exit from the international market. In the early 1960s, Western Union advocated repeal of its divestiture obligation under Section 222 on the grounds that there had been significant changes in the telecommunications industry during the intervening 20 years since the enactment of Section 222. Although repeal legislation was considered by the Senate in 1962 and 1963, it was not enacted by Congress. Western Union finally divested its international operations to WUI on September 30, 1963; and the telegraph company contracted with WUI -- as an integral part of the transaction -- that it would not enter into the international telegraph operations prior to September 30, 1988.

B. Western Union's Uncontrollable Conflict-Of-Interest Position Between The Domestic And International Markets Reappeared During The 1975-1981 Timeframe

1. In 1975, Western Union commenced its campaign to re-enter the international market. Believing that it had authority to authorize Western Union to render new international services not provided by the IRCs, the FCC authorized Western Union to offer international mailgram service. Incidentally, the exclusive arrangement between Western Union and the U.S. Postal Service has frustrated WUI's efforts to provide its own international mailgram service. A separate Congressional inquiry into that anti-competitive arrangement is warranted.

The FCC reiterated in 1975 that Western Union:

> "[W]as in a position virtually to drive an international carrier out of business were it so inclined....We agree with WUI and RCA that a construction of the divestment provision which would permit WU to re-enter the same international operations the day after it divested its prior operations would render the requirement meaningless and absurd. It makes no sense, in view of the purpose underlying the divestment clause, to require divestment if WU could re-enter international PMS operations in competition with the IRCs."

The U.S. Court of Appeals for the Second Circuit reversed the FCC and held that Section 222 was a continuing bar to Western Union's entry into the international market. In reaching its decision, the Court carefully reviewed the legislative history of Section 222, and the FCC's regulatory experience under the statute. The Court concluded that Congress clearly intended to bar Western Union from the international sector.

2. In 1980, the Court found Western Union's renewed international activities to be "contemptuous." In 1979, without even seeking FCC approval, Western Union

again invaded the international, overseas market by routing telex calls circuitously via Canada and Mexico, thus diverting U.S. industry revenues to these two contiguous foreign countries. Following IRC complaints, the FCC ruled that Western Union did not need any additional authority to route calls via Canada and Mexico.

However, the Court of Appeals for the Second Circuit found that Western Union was again in violation of Section 222. Thus in 1980, the Court was forced to twice order the termination of Western Union's overseas telex service via Canada and Mexico; and the Court found Western Union's conduct to be "contemptuous."

3. Western Union has thwarted the IRCs' interconnection requirements at their additional gateway cities. During the last 5 years, Western Union has denied the IRCs' interconnection requirements. To this day, Western Union interconnects with WUI for telex service at only two of WUI's 26 operational gateway cities. Western Union's arbitrary refusal to interconnect has degraded the quality of international telex service and has increased the costs to the customers. Accordingly, telex users in the hinterland often cannot reach the IRC of their choice at the nearest gateway city. Instead, telex calls are often backhauled and circuitously routed through unnecessary switches, with resulting service deterioration. Telex users have been forced to pay higher Western Union zonal charges to reach a distant IRC gateway city because Western Union has denied an IRC interconnection at gateway cities closer to the users.

Western Union has selected its favorite IRC for preferential interconnections. Moreover, Western Union has entered into a series of preferential agreements with this particular IRC, whereby this IRC would receive additional traffic captured by Western Union and would be "guaranteed" an amount of traffic in the event of any repeal of Section 222 even if Western Union became its competitor. A clearer case of unlawful market divisions between competitors would be hard to find. In return, this favored IRC agreed to make its overseas channels available to Western Union to further its activities which were characterized as "contemptuous" by the Second Circuit.

The FCC has characterized Western Union's favored treatment of this particular IRC by declaring:

> "A clearer case of unreasonable discrimination can hardly be imagined."

Although the FCC ordered Western Union on July 22, 1980 to interconnect with each of the IRCs on a nondiscriminatory basis in certain of their new gateway cities, now, almost one year later, these interconnections still have not been provided. Western Union has engaged in a bewildering series of legal and regulatory maneuvers, during the last year, designed to thwart the FCC's mandate for interconnection.

4. Western Union has coerced the public, dependent upon it for domestic service, to use Western Union's overseas service. During the recent one-year period (September 1979 -- September 1980) when Western Union engaged in its unlawful overseas telex service, it emphasized its domestic telex/TWX monopoly in order to coerce its domestic customers into using its overseas service in preference to the service of the international record carriers.

Western Union's "promotional" telex message transmitted to the public contained the following:

> "Beginning July 1 our repair personnel will give special priority service to any TLX/TWX machine needing attention, if that machine is used to send overseas messages via Western Union's International Telex Service. To offer this, those that do not utilize the service will be placed at the bottom of the call order no matter when the repair order was placed. Even if an overseas customer orders repairs after you, you will be called on after him. This could delay your repairs for days."

Anticompetitive conduct of this nature is a harbinger of what the public and the international telecommunications industry can expect in the future from yet another international foray by Western Union.

5. Western Union's domestic monopoly has been harmful to the public. Section 222 conferred enormous monopoly benefits upon Western Union. However, the public has not benefited from Western Union's monopoly operations during the last four decades.

Western Union never fulfilled all of its promises to the FCC to integrate and improve the combined telex/TWX operations. The promised two-way conversational mode of communications between domestic telex and TWX subscribers was never implemented. During the last 14 years, domestic telex usage charges have risen by more than 100% and station equipment/access line charges have been increased by 250%. Western Union has failed to roll-back any of these rate increases contrary to its promises made to induce FCC rate-increase approvals.

There have been at least 11 general increases in domestic telegram rates during the last 16 years constituting: (1) a 525% increase in the charges for a 15-word coast-to-coast full rate telegram requiring physical delivery; and (2) a 285% increase in such a telegram not requiring physical delivery.

Rate increases for overnight telegrams have been even greater.

During the last 15 years, the international record carriers have been compelled to absorb more than a 100% increase in their telex interconnection payouts to Western Union, and nearly a 100% increase in their interconnected telegram payouts. The IRCs are now confronted with drastic telex interconnection rate increases which have just been proposed to the FCC by Western Union. Although the IRCs are caught in the same inflationary spiral as Western Union, they have dramatically reduced their rates and improved their services during this same timeframe, as indicated earlier in my testimony.

The FCC has recognized the deficiencies of Western Union's domestic monopoly. About two years ago the FCC held:

> "Thirty-five years of [Western Union] monopoly have not produced a vigorous, publicly available record communications service. Rather, it has produced ever-increasing telegraph rates, diseconomic subsidies from more vigorous services and increasing volume declines as the public finds and uses other services more closely tailored to its needs."

Now, Western Union sees an opportunity to extend its domestic monopoly into the international marketplace. If it can utilize its domestic monopoly to engage in its familiar anticompetitive tactics, it might be able to divert from the IRCs the substantial international telex volumes that transit its domestic telex/TWX networks. Western Union might even seek to acquire an IRC for its international circuits and overseas operating agreements, thus reducing the existing competition internationally. Section 222 expressly prohibits Western Union from acquiring an IRC.

The domestic telegraph monopoly disease now threatens the viable, competitive international marketplace. The international consumers would be placed in the same peril of monopoly rate increases and service deteriorations as plagued their domestic counterparts.

IV. ANY LEGISLATION TO REPEAL THE STATUTORY BAR TO INTERNATIONAL MARKET ENTRY BY WESTERN UNION SHOULD CONTAIN A REASONABLE TRANSITION PERIOD AND PROCOMPETITIVE SAFEGUARDS

If the statutory bar to Western Union's international market entry were to be repealed or modified, procompetitive safeguards and a reasonable transition period are essential. Otherwise, entry by the domestic, telegraph monopoly carrier will be destructive of competition in the international record carrier market.

Transition Period. The IRCs need a reasonable transition period to prepare for any international market entry by the domestic monopolist, Western Union.

As indicated earlier in my testimony at pages 9-11, WUI endeavored throughout the decade of the 1970s to expand our direct international services to the public located beyond the confines of the corporate boundaries of the cities of New York, San Francisco, and Washington. Western Union opposed our expansion endeavors before the FCC. Generally, we were unsuccessful. We were not even permitted to serve directly suburban Washington customers, who relocated from the central city. These customers were, instead, forced to access WUI through a middleman -- Western Union -- with resultant inferior service. Even during a lengthy Western Union labor strike in the early 1970s when customer access to WUI via Western Union was impaired, Western Union successfully opposed WUI's efforts before the FCC temporarily to extend our direct international service to the hinterland of the U.S. In April of this year, Western Union successfully defeated our attempts before the FCC to provide the foreign press with direct international telex service at Cape Canaveral during the Columbia space shuttle launch. Even NASA pleaded our case before the FCC, but the foreign press was relegated to an inferior, and sometimes unavailable, Western Union bottleneck facility in order to access the IRCs.

Today, Western Union effectively retains its domestic telex/TWX monopoly, principally due to Government action.

Western Union's dominant domestic telex/TWX networks serve 140,000 U.S. customers for domestic calls and for international calls. WUI's competitive international telex network has less than 5% of the number of Western Union's subscribers, and is licensed for international service only. Under current FCC policy (which hopefully is changing), we must block our subscribers from calling one another. Western Union can now serve the public anywhere throughout the U.S. Mainland. By contrast, WUI and the other IRCs are restricted to designated cities. WUI is operational in only 26 cities, and we have only last week been authorized for 9 additional cities.

Therefore, if Congress were to authorize Western Union to enter the international market abruptly on a "flash cut" basis, WUI and the other IRCs would be relegated to an impossible noncompetitive position.

Accordingly, a reasonable transition period, prior to any Western Union overseas market entry, is essential. During that period, each IRC must be accorded the opportunity to:

1. Expand its direct points of operation within the U.S. to as many cities as are required in the business judgment of each IRC;

2. Unblock its message switching equipment to enable its subscribers to call one another domestically, as well as to place international calls;

3. Interconnect its relatively small telex network with Western Union's dominant telex/TWX network so that the IRCs' subscribers can call anyone on the Western Union network;

4. Take whatever steps are necessary to ensure that no State or local jurisdiction will object to IRC subscribers within a given State or city calling anyone within the same jurisdiction on an IRC network; and

5. Take the necessary operational and marketing steps effectively to implement all of the above.

Interconnection And Public Access. As a result of nearly 40 years of governmental authorization and protection of a domestic telegraph monopoly for Western Union, that company controls access to the IRCs for a substantial segment of the public. Thus, Western Union is in a position to close this access and to divert about half of the IRCs' business to Western Union overseas routes if Western Union became legally eligible to enter the international market.

As indicated at pages 22-23 of my testimony, Western Union has denied to the public access to new IRC gateway cities for 5 years, and has thwarted an FCC interconnection order for one year. The FCC has been unsuccessful in this regard, in WUI's opinion, because it has permitted Western Union to control the action by unilaterally proposing, withdrawing, and resubmitting the operational and economic terms and conditions governing interconnection with the IRCs. In any event, the FCC's interconnection order has not been effective.

Accordingly, any legislation empowering Western Union to enter the international market should mandate -- as a pre-condition to such entrance -- that Western Union provide both fair and nondiscriminatory access to, and interconnection with, the respective network of each international carrier, including any future overseas network of Western Union.

Any future overseas operations of Western Union should be considered to be the operations of an independent international carrier. This requirement will enable the FCC and the international carriers to scrutinize Western Union's self-dealings and will provide a benchmark for enforcement of the nondiscriminatory provisions which are essential to full and fair competition in any legislatively restructured international record communications industry. This Western Union separations requirement can be implemented, in our opinion, without the need for separate subsidiaries.

Equitable And Nondiscriminatory Message Interchange. Similar to the IRCs' need for interconnection and public access to their respective networks via Western Union's bottleneck facilities, the IRCs also need protection against Western Union's diversion of overseas telegrams to its own international arm. Pages 18 and 19 of my testimony show the history of Western Union's diversionary tactics in this regard.

Accordingly, any legislation to repeal Section 222 should mandate that Western Union interchange overseas telegrams with the international record carriers on an equitable and nondiscriminatory basis. The Western Union separation requirement, outlined above, will provide the benchmark for enforcement of the nondiscriminatory provisions with respect to overseas telegrams.

Domestic Market Entry By IRCs. During the transition period, described above, the IRCs should be accorded the opportunity of unlimited domestic market entry. Although WUI has recently been authorized to operate in 35 cities in the U.S., these operations are confined to international services. WUI must have the opportunity to provide domestic services as well. Although current laws do not bar domestic market entry by the IRCs, the FCC has generally precluded any such entry as a matter of policy. Therefore, any new legislation should clearly indicate that the IRCs are not barred from entry into the domestic marketplace.

Even with domestic market entry, the IRCs' networks would remain primarily international in nature, and secondarily would become available for interstate services. The tertiary use of these networks would be for intrastate and local communications. In order to ensure full public utilization of the IRC networks, any new legislation should preempt any State or local jurisdiction. Otherwise, Western Union might be able to delay full utilization of the IRC networks and continue to enjoy unearned competitive advantages.

V. CONCLUSION

The issue of what to do about international market entry by Western Union, if anything, has been superficially before Congress for several years. WUI would like to see the matter laid to rest one way or the other. However, an improvident or premature legislative action would not be in the public interest. U.S. international consumers are entitled to the most efficient and reliable service at the lowest reasonable rates. The objective should be a full and fair competitive marketplace.

Immediate and unconditional international market entry by the domestic telegraph monopoly carrier will substantially lessen competition. It might even lead to monopolization of the international market. Ordinarily, competition is preferable to monopolization. Even in the telecommunications industry, where regulation has been considered to be the surrogate for competition, history has shown the benefits of competition over monopolization, as indicated by the FCC in its quotation on page 25 of this testimony.

Thank you, Mr. Chairman, and all the members of this Committee and its diligent staff.

STATEMENT OF EUGENE F. MURPHY
CHAIRMAN OF RCA GLOBAL COMMUNICATIONS, INC.
BEFORE COMMITTEE ON JUDICIARY
JUNE 10, 1981

Chairman Thurmond and members of the Committee, my name is Eugene F. Murphy. I am Chairman of RCA Global Communications, Inc. (RCA Globcom), a common carrier of international record communications services for more than 60 years. I appreciate the opportunity to appear before you today.

At the outset, I would like to stress that, unlike other segments of the communications industry, international record communications services have always been provided in a highly competitive market environment. We are not here seeking protection from competition. Rather, we are here in the hope that the Committee will recognize and take steps to deal with the unique ability of those entities that maintain monopoly market power to use that power unfairly to prevent others from competing. Although AT&T and Comsat also wield market power, in light of recent events, I will primarily address the threat to fair competition posed by Western Union's entry into the competitive international record market.

As aptly stated by Senator Laxalt in his remarks on the Senate floor last Tuesday, as government moves toward substituting competition for regulation, it must at the same time make certain that "competition will replace regulation in an orderly and responsible fashion to assure its viability and vitality."

Regrettably, however, as pointed out by Senator Laxalt and other members of this Committee, measures that would repeal outright Section 222 of the Communications Act fail to meet this goal because of the lack of adequate consideration given to pro-competitive safeguards to protect against a lessening of existing international communications competition. Unconditional repeal of Section 222 will benefit only Western Union at the expense of other companies and their employees. We believe that, at a minimum, any repeal of Section 222 must contain transitional provisions that (1) assure that the FCC authorizes the international carriers to provide domestic services immediately; (2) provide for adequate interconnection with Western Union for international and domestic service; and (3) give the international carriers a catch-up period of at least three years to establish a foothold in domestic record communications, over which Western Union has had a 38-year monopoly

Congress originally enacted Section 222 expressly to prevent The Western Union Telegraph Co. (Western Union) from using the monopoly it acquired in domestic record communications to the detriment of the competitive international carriers. As a practical matter, that monopoly still exists. As noted by the FCC earlier this year:

> "The public switched record submarket consists almost entirely of Western Union's Telex/TWX service. Since AT&T discontinued TWX service in 1971 and sold some of the associated facilities to Western Union, Western Union has maintained virtually a 100% share of this market."

The FCC also recently said:

> "WU's telex/TWX network, extensive as it currently is, obviously gives it a substantial advantage over potential competitors."

In contrast, competition in international communications, if anything, is increasing. The FCC has been pursuing a policy of virtually unlimited multiple entry, opening the doors of this marke to any qualified applicant. For example, two smaller international record carriers, TRT and FTC, have made substantial inroads, and th FCC's pro-competitive policies have resulted in the addition of new carriers and promise still further entry.

The only threat to this trend toward increased competitive opportunity in international communications is the power of monopoly-based entities to use advantages obtained by a statutory-sanctioned monopoly to restrict competition by others. Indeed, it would be ironic if monopoly-based interests are allowed, in the name of competition, to enter the already highly competitive international record communications market and destroy the healthy competitive structure of that market.

Competitive Structure of the International Record Communications Market

The international communications market is divided into two basic segments -- telephone and record. The telephone segment, which accounts for approximately two-thirds of the total market, is virtually an AT&T monopoly. The record segment, which repre- sents the remaining one-third, is and has always been fully competitive. In terms of revenues, telephone in recent years represents approximately $1.1 billion annually, compared to annual record revenues of approximately $500 million. The record segment of the international communications market is thus relatively small.

Furthermore, because of its competitive character, and the fact that the domestic record services were provided basically by monopolists, special provisions have been necessary to preserve the competitive integrity of the international market. These include Section 222, which prevented Western Union, which is a domestic monopoly telegraph carrier, from serving the international market directly and mandated fair dealings between that domestic monopolis and the international carriers. Before this statute is dismantled in a summary manner, we believe that some Congressional consideration should be given to the effects of such action on the maintenance of fair competition.

At the present time, five companies -- RCA Globcom, ITT World Communications Inc. (ITT Worldcom), Western Union International, Inc. (WUI),* TRT Telecommunications Corp. and FTC Communications, Inc. -- compete actively in the provision of a full range of international record communications services. These services include teletypewriter exchange (telex), telegrams, leased (private line) channels, facsimile and data transmission between the U.S. and over 200 points around the world. In addition to these companies, at least 10 others are now authorized by the FCC or have FCC applications pending to provide specialized record and data communications in the international market, including Hawaiian Telephone, Graphnet, GTE Telenet, Consortium Communications International and International Relay, Inc.

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*WUI is not affiliated with Western Union but rather is an independent company that acquired the international facilities divested by Western Union as a consequence of Section 222.

Despite the presence of larger international record carriers such as RCA Globcom, ITT Worldcom and WUI, the economics and market structure are such that the smaller international carriers have fared successfully, and there has been room for new entrants. For example, TRT's telex revenues have tripled in the past five years, and FTC's market share has grown. The ability of smaller companies to survive and grow demonstrates the existence of an active and dynamic market.

Telex, which has been in worldwide use for over 40 years, is the most important international record communications service, accounting for 60 percent of reported international carrier revenues in 1979 and 1980. Telex is a switched teletypewriter service, which is a dial-up service much like telephone, except that, in telex, communications are transmitted between two electronic typewriters (or "teleprinters") in written form.

The U.S. international record carriers obtain their overseas telex traffic in two basic ways. Each maintains a telex network limited to a few major U.S. cities, which can be used for transmitting and receiving overseas telex traffic. For example, RCA Globcom has about 9,000 telex machines connected to its network, 80 percent of which are in three so-called "gateway" cities (New York, San Francisco and Washington, D.C.), which were the only areas in the continental U.S. we could serve directly from 1943 to 1976.

The other main source of our overseas telex business is the 140,000 teleprinter machines on the Western Union monopoly system. These teleprinters now supply over half of all the international telex traffic handled by the international record carriers. While FCC policy prevents an RCA Globcom customer in New York from using his telex machine to communicate with another RCA Globcom customer in the U.S., Western Union machines have dual capacity, in that they are able to communicate with other Western Union customers and, via the services of an international record carrier, with foreign telex users.

Under arrangements that have lasted two decades or more, RCA Globcom's international network interconnects with Western Union's domestic networks at New York and San Francisco for the exchange of international traffic only. Currently, Western Union's customers pay a two-element charge for outbound international telex traffic. One element consists of Western Union's domestic charges from its customer's machines to the office of an international record carrier. The other element is the payment to the international record carrier for transmission overseas, which charges are shared with the country receiving the message. For inbound traffic, international record carriers pay, out of their share of charges from the sending country, Western Union for delivery of telex traffic from the point of entry to the premises of Western Union's customers.

Western Union is different from an ordinary competitor seeking to enter a new market. In the case of international telex, customers generating half of the international traffic are already hooked up to Western Union's lines, due to its long-standing domestic monopoly and the fact that, unlike RCA Globcom and the other international carriers, Western Union's customers can use Western Union's network for both domestic and international calls Therefore, if permitted to enter international communications, Western Union could effect a substantial diversion from the other literally by the "flip of a switch." Indeed, Western Union has forecast to the FCC that it will obtain the equivalent of 40 perc of the international telex business* -- a larger share than any international carrier now has -- within three years. This is clearly not a typical competitive situation; rather, it is the ty of market takeover that could only result from the exploitation o monopoly market power.

As a result of the FCC's recent structural changes, the international record industry has become increasingly competitive. As a history of declining international rates shows, this industr has been passing on the benefits of increased automation and technical innovation to users. Competition in this industry has also stimulated the provision of new services and the application new technologies to meet emerging needs. In telex alone, the international record carriers have pioneered service innovations such as computerized switching, single-digit dialing, store-and-forward arrangements, multi-subscriber calls, and camp-o which keeps redialing a foreign number until it is no longer busy. Each carrier faces continual pressure to upgrade its system with t latest technology in order to retain the patronage of customers wh can readily take their business elsewhere.

In sum, the international record carrier industy is a healthy business, in which competition thrives and brings to the market increasingly modern technology and continually lower rates, despite inflation. Repeal of Section 222, without adequate and appropriate safeguards, would needlessly threaten this healthy competitive industry.

Domestic Record Communications Market Structure

In comparison to the competitive, diverse, and multi-carrier industry that provides international record services, domestic record communications are dominated by a single company -- Western Union. Western Union acquired its dominant position as a result of Section 222 of the Communications Act, which first enabled it to acquire its only competitor, thereby giving it a monopoly over domestic telegram service and later enabling it to acquire AT&T's TWX system,* the only competing domestic telex network. As a express condition of obtaining a domestic monopoly, Western Union agreed to divest itself of its international operations and remain out of overseas services.

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*FCC application, File No. I-T-C-3005 at 10.

Over the past decade, Western Union has transformed itself from a financially troubled telegraph company to a highly-competitive and broadly-based communications company. This has resulted in large part from Western Union's diversification out of regulated communications and into high-technology unregulated services, the revenues of which are becoming increasingly responsible for Western Union's profitability. Telegram, which used to constitute the lion's share of Western Union's business, now accounts for only a fraction of its overall revenues.

While international telex revenues are vital to the survivability of the international carriers, they are much less important to Western Union. Indeed, telex/TWX in total represents only about 35 percent of Western Union's revenues from all sources. The domestic carriage of international telex, which Western Union complains is being harmed by the expansion of the international carriers' gateway telex networks, is only 10 percent of its revenues, and Western Union has not contended that it has lost all or a majority of this business. On the other hand, international telex, as noted, accounts for 60 percent of total international carrier revenues and is the only international service earning a return as high as the 12.75 percent recently approved as fair by the FCC for AT&T's monopoly services. A substantial loss of this business, which would be occasioned by Western Union entry without safeguards, could have a severe impact on the future ability of the international record carriers to compete.

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*TWX is functionally equivalent to telex in that it is also a switched record teletypewriter service that enables one TWX subscriber to exchange written communications with another TWX subscriber. Because TWX and telex employ different codes and protocols and operate at differet speeds, the two services are not directly compatible with each other. In addition, while TWX service is confined to the United States and Canada, telex is worldwide.

Western Union's telex/TWX subscribers can use that company's services both for domestic communications and, via interconnection with an international record carrier, for overseas communications as well. Western Union's services thus can fulfill both a need for domestic as well as international record communications, while ours can be used for the latter purpose alone.

By applying the market definition based upon the reasonable interchangeability among products as to price, quality and use,* the FCC has found that telex/TWX service constitutes an important and distinct submarket, in which Western Union enjoys a monopoly status.** As put by the Commission:***

> "Telex and TWX are the only significant domestic switched networks dedicated to teletypewriter, or written record service on an exchange basis. Thus, WU's market share for this type of service approaches 100%. These networks operate principally in the circuit switched mode (a form of real-time switching), but also offer the optional use of message switching so that additional features are available including multiple-addressed message service, store and forward service between Telex and/or TWX stations, and access to other services such as PMS. All Telex and TWX subscribers are issued combined Telex/TWX directories so that access to essentially all other subscriber stations is readily available on a direct-dial or store and forward basis. Although a substantial market comprised of point-to-point and switched teletypwriter requirements exists outside the realms of Telex and TWX (e.g., Autodin and Advanced Record Service (ARS), switched private line networks provided by Western Union to the government, Series 1000 and Low Speed Channel private line service provided by AT&T and Western Union respectively, and the very substantial amount of use of the nationwide telephone network for record type services), such alternative services may not be viewed as ready substitutes

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*United States v. E.I. DuPont de Nemours & Co., 351 U.S. 377 (1953).

**Competitive Carrier Rulemaking, 85 FCC2d 1, 24-25 (1980).

***Competitive Carrier Rulemaking, 77 FCC2d 308, 354 n.65 (1979).

> to Telex and TWX. Western Union's Telex and TWX domestic services also include a substantial amount of use associated with the domestic handling of international traffic, thus indicating an even more privileged position in the domestic market. Moreover, it is often essential for a domestic Telex/TWX user, particularly in the hinterland, to subscribe to Western Union's service in order to have ready access to the international Telex services of the IRCs." (Emphasis supplied)

In connection with the Commission's final decision in the Competitive Carrier Rulemaking, Western Union submitted a study showing that, of all other record services available, the only services comparable to telex/TWX in terms of price, quality and delivery term were high-speed facsimile and low-speed facsimile. Nevertheless, the Commission stated:*

> "While some have predicted that the facsimile market will grow rapidly, we have seen little evidence in this record or in our own analysis to show that WU's position in the domestic switched record market has declined to the extent that it can be said that customers now have 'reasonable substitutes' readily available. Moreover, Western Union now serves between 100,000 and 150,000 customers interconnected with its network. We note that the telecommunications market places a value on switched service networks being capable of serving a large universe of addresses. WU's Telex/TWX network, extensive as it currently is, obviously gives it a substantial advantage over potential competitors." (Emphasis supplied)

The FCC went on to conclude that, because of its dominance in a discrete and highly important domestic communications submarket, Western Union possessed "market power," which the Commission equated with the ability to price, terminate or reduce these services unreasonably or to discriminate among customers unjustly. As the record before the FCC shows, Western Union has wielded its dominance to the detriment of its would-be competitors and its own captive customers, who have nowhere to turn.

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*85 FCC2d at 25.

In its Domestic Public Message Services (PMS) decision,* the Commission took steps to end Western Union's legal monopoly over domestic record communications by allowing Graphnet to offer a competing public telegram service. Although the Commission has repeatedly hailed the end of Western Union's *de jure* monopoly as a result of PMS, Western Union's *de facto* monopoly has continued unabated. While extolling the benefits of additional competition in the international sphere, Western Union has adamantly opposed dilution of its domestic monopoly. More significantly, the Commission has failed to to put into practice the principles announced in its PMS decision.

For example, RCA Globcom applied in August 1980 for authority to offer domestic telex services in competition with Western Union, but the Commission has failed to act on this. A number of other international record carriers, whose authority is similarly limited to overseas services, have also applied for domestic telex authority But the Commission has apparently imposed a moratorium against any new entry whatsoever by international carriers in the domestic record market, despite the numerous applications it has granted in the last year alone for international authority.

In 1976, the Commission tentatively found that the usefulness of international telex would be enhanced by permitting the exchange of calls between customers of the international telex carriers with those of Western Union's switched record services.* This would enable a customer on RCA Globcom's telex network, through an expanded interconnection with the Western Union system,** to use his telex equipment not only for overseas communications but as well to exchange domestic communications with Western Union's customers.

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*71 FCC2d 471 (1979).

*Customer Use of Telex Service, 76 FCC2d 61 (1976).

**As has been noted, Western Union, which controls the qualitative as well as the quantitative aspects of interconnection, has restricted the interconnection available to international carriers to that for through international services only, which enhances the usefulness of Western Union services without posing any threat to its monopoly position.

Western Union opposed this proposal, and, five years and innumerable rounds of pleadings later, the Commision has yet to issue a proposed rule on this subject. At the same time, the FCC ordered the competitive international carriers to interconnect with each other on demand.

For the Committee to have some appreciation of where we are in attempting to obtain interconnection for domestic services, it should be remembered that MCI Communications had the right to interconnect with AT&T as early as 1974. In a seven-year history strewn with innumerable FCC proceedings and court litigation, MCI is just now beginning to make its presence felt in domestic voice communications. As a result of Western Union's opposition and the FCC's inaction, we have yet to attain the stage at which MCI was seven years ago.

Barriers Erected Against Competition by Western Union

Western Union has manipulated its rate structure to raise entry barriers that ensure that domestic telex will remain a protected enclave from new entry if the Commission ever implements its pro-competitive policy in domestic record communications. Just as virtually every person with a need for domestic voice communications is a customer of AT&T, virtually every person with a need for domestic record communications is a Western Union customer. As MCI realized was the case with AT&T, access to Western Union's customer base is therefore a sina qua non for successful entry into domestic record communications by other carriers.

In order to foreclose the possibility of any entry by other carriers, Western Union's tariffs specify that other carriers using its services must pay the same rates as the public. Thus, in order to offer an interconnected service so another carrier's customer can communicate with a Western Union customer, any carrier that obtains interconnection for domestic services must pay Western Union its current public rate of 34 cents a minute. Because such a carrier interconnecting with Western Union incurs expenses of its own in offering service, Western Union's rate structure forces an insolub and no-win dilemma upon would-be entrants: a new entrant must dea with its own costs by either absorbing them in order to be competitive with Western Union's customer-to-customer rate, in whi case it would earn a negative return; or it could pass on some of these costs to its customers, in which case its rates would be higher than Western Union's and thus it would fail to attract any business.

In proceedings before the FCC, Western Union said it was justified in charging carriers the same rates as its public users, although it was shown by other parties that Western Union can provid services to common carriers at 23 percent less expense than it provides such services to the public. After steadfastly denying f four years that it had any studies showing the costs of serving other carriers, Western Union finally was made to produce such a study, which shows that its returns on telex services provided international record carriers were nearly twice as high as on its services to the public.

Effective July 1980, the FCC allowed the international record carriers to expand their international operations outside the thre traditional "gateway" cities (New York, San Francisco and Washington, D.C.) in which we traditionally operated, plus the two other gateways (Miami and New Orleans), that were added in 1976. Although we are now authorized to operate in 32 cities,* our authority is still confined to providing international services only from these points. We cannot offer domestic service because of the FCC's refusal to act on our domestic telex application and its failure to resolve the domestic interconnection rulemaking. And our experience has been that it is extremely difficult to uproot an entrenched monopoly. After nearly one year of operation, our customers are still largely concentrated in the environs of New York and the other original gateways.

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*Western Union by comparison serves some 1,600 cities in the continental U.S.

Western Union's Abuse of Monopoly Status

Western Union has been able to exploit its monopoly status by curbing our operations as it positions itself to enter international communications, in anticipation of the repeal of Section 222. This is the same brand of "competition" it would and could expect to provide if it is allowed to operate internationally without appropriate safeguards. The following examples illustrate the ways in which Western Union has been able to abuse its monopoly to our detriment:

- Western Union has clearly demonstrated that it will use its dominant market power in anticompetitive fashion. Indeed, in September 1980, it was cited for contempt by a federal appeals court as a consequence of its anticompetitive behavior in promoting an illegal service despite a court order to the contrary.*

- Western Union has refused to interconnect with us in the two gateways we were authorized to serve in 1976, notwithstanding a Commission order to do so. Western Union's refusal to interconnect with us at these points is made all the more unjustified by the fact that, at one of these cities, it supplies one of our competitors with the same interconnection arrangements that it denies to us. This refusal has enabled Western Union to collect millions of dollars of overcharges from the international carriers and an untold amount from the public.

- Western Union has also refused to interconnect with RCA Globcom at other cities where we have been authorized to operate since 1980, causing RCA Globcom and Western Union customers to pay hundreds of thousands more in domestic charges for Western Union's services than would otherwise be the case.

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*ITT World Communications Inc. v. FCC, 635 F.2d 45 (2nd Cir. 1980).

- Western Union has proposed a series of interconnection tariffs containing substantial charges and onerous terms for interconnection arrangements for the international record carriers and other common carriers. Although Western Union's usage revenues continue to grow, it is nevertheless now seeking to charge additional separate fees for interconnecting arrangements formerly included in its usage charges to the other carriers.

- Significantly, the only type of interconnection that these tariffs would allow to international carriers is for through international services. Western Union has opposed every effort by international carriers to use existing interconnection arrangements to accommodate traffic between the customers of the international carriers and Western Union customers as well as permitting traffic between Western Union customers and overseas telex users.

- Access charges that Western Union has proposed for interconnection are higher than the access charges it levies upon other public users of its services to whom it provides identical interconnecting arrangements.

- Western Union has continually attempted to enter into preferential arrangements with certain international record carriers not given to others.

- Western Union has used its monopoly position to increase telex rates in order to exact still more money from the captive users of its service for which the FCC has found there are no reasonable substitutes. For example, in 1974, a Congressional study found that, since 1945, Western Union's rates for full-rate telegrams had increased by 3,775 percent and that Western Union had raised its rates 19 times. As soon as its dominance had been established in telex by acquiring its only rival, TWX, Western Union started this pattern all over again. For example, Western Union has raised its telex and TWX rates three times since 1978, causing the FCC's own staff to find that telex and TWX were earning excessive rates of return.

Section 222 of the Communications Act Still Serves a Useful Purpose

As the Committee is aware, Section 222 of the Communications Act was enacted to provide an antitrust exemption for an otherwise prohibited merger. In return for obtaining a domestic monopoly, Western Union was prohibited from abusing this monopoly to the detriment of the competitive segment of the international record industry. Specifically, Western Union was required to divest its own international operations, in order to safeguard competitors from the possibility that it would use its market power to feed its own international services with traffic it gained domestically pursuant to this monopoly. For similar reasons, Western Union was prohibited from re-entering international communications, either directly or pursuant to a merger. Finally, it was required to treat firms engaged in international record business, with whom it formerly competed, fairly and equitably, both in the distribution of traffic and in the division of charges.

We are concerned that unqualified and unconditional repeal of Section 222 would introduce dangerous trends of concentration in the international record industry, keep out new competitors, damage existing competitors and allow Western Union to export its domestic monopoly and anticompetitive practices. In particular, repeal of Section 222 without safeguards would:

- Permit Western Union to use its monopoly power to the detriment of other carriers and to create economic barriers to new entry;
- Permit mergers between Western Union and international record carriers, which are now prohibited by Section 222; and,
- Eliminate provisions in Section 222 requiring fair and equitable distribution by Western Union of outbound international record traffic, which Western Union would seek to retain for itself.

Measured by virtually any standard, Western Union's dominance clearly overshadows any international record carrier and, for that matter, the international record industry as a whole. Western Union's 1980 operating revenues were three times as large as RCA Globcom's and nearly one and a third larger than the operating revenues of the international record carriers combined.

But Western Union's most important asset, and one that gives it a decided advantage if it were allowed to re-enter the international arena without restrictions or other qualifications, is a built-in customer base of over 140,000 telex and TWX subscribers, or nearly 10 times the total number of direct subscribers to all international record services. It is the substantial volume of overseas traffic generated and received by this network that is the lifeblood of the international record services.

As I have previously mentioned, a number of Western Union's 140,000 customers have needs for international record communications that are currently satisfied by the international record industry. All international record carriers rely to a very high degree on Western Union's facilities to pick up and deliver a large share of their international traffic, both from outside the limited number of cities that international record carriers are permitted to serve and from firms which subscribe to Western Union's services because they have needs to exchange domestic as well as international communications.

Estimates vary, but we believe more than half of all international telex either originates or terminates with Western Union customers. But this does not tell the whole story of how Western Union can immediately dominate the international record market. Of the international traffic which is now handled on the Western Union system, more than 50 percent of total inbound telex traffic consists of traffic generated by monopoly networks overseas which terminates on customer terminals connected to the Western Union system. In the case of an outright repeal of Section 222, it is reasonable to assume that there will be a tendency on the part o the foreign telecommunications entities, which are monopolies themselves, to turn over all traffic addressed to customers with Western Union terminals directly to Western Union, rather than routing this traffic through an international record carrier, as at present. This is not competition but rather market allocation.

If Section 222 is repealed, and assuming Commission approval, Western Union can, almost overnight, deprive international record carriers of one-third or more of their telex traffic, which, as I have explained, is the breadwinner of this business.

In addition to losing all inbound traffic destined for the Western Union system, international record carriers would have to struggle against unfavorable odds to retain an adequate share of outbound Western Union traffic. As shown by its aborted attempt to evade the bar of Section 222 by diverting its international traffic to Canadian and Mexican carriers in 1979-80, Western Union will resort to any method possible to retain traffic on its own system. For example, during its Canada-Mexico venture, Western Union informed its customers that priorities in repair would go the machines of those customers that used its international services. Not a single machine of customers who continued to route their international traffic through an international record carrier would be repaired until Western Union had completed all repairs for customers using its illegal international services. This is the kind of unsubtle inducement that Western Union can exert over its captive customers to maintain control of their outbound traffic.

We do not anticipate that Western Union will experience any substantial delays in obtaining rights to operate foreign countries. Because of the sizeable volume of telex traffic Western Union controls, the telecommunications carriers of both Mexico and Canada eagerly entered into operating agreements with Western Union to handle its overseas traffic; and it is likely that the same incentives would be applicable to other countries as well. In addition, interim arrangements would be available for Western Union's overseas services to become operational within a short period.

The Impact of Western Union Would Be Accentuated by Other FCC Proposals

Finally, the potential losses that entry by Western Union could inflict on the international record industry must also be evaluated in a light of vulnerability of these services to losses inflicted by implementation of other FCC proposals that would permit entry by AT&T and/or Comsat into the international record market.

Comsat, which has a legal monopoly under the Communications Satellite Act of 1962 of international satellite circuits, now functions in a "carriers' carrier" role. In this capacity, it leases facilities to all the international common carriers, including AT&T, which in turn use these facilities in their services to the public.

The FCC has proposed to permit Comsat to enter the retail market, both in supplying communications services to the public and in providing satellite space segments alone for large users. Because Comsat is the only U.S. entity which presently may obtain access to interntional satellite circuits at wholesale rates, if it is allowed to provide retail transmission services directly to users, it would have an inherent competitive advantage by being able to place other carriers in a textbook situation of wholesale-retail squeeze.* The end result would be the establishment of monopoly conditions in place of competition for international satellite services. For example, RCA Globcom estimates that 40 percent of its leased channels, our second largest source of revenue after telex, are used by the federal government. Thus, adoption of this one proposal would mean that the international record carriers would likely experience a substantial loss of this business to Comsat.

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*See United States v. Aluminum Co. of America, 148 F.2d 416, 436 (2nd Cir. 1945).

We have proposed that, if Comsat is to be allowed to provide retail services, the international carriers should be authorized to obtain cost-based access to the international satellite space segment, either through a cost-sharing lease arrangement or through an investment interest in the satellite facilities themselves, such as by indefeasible right of user. NTIA has supported, in the past, the concept of cost-based access to Intelsat. The FCC has also noted that cost-based access could produce lower rates to users.

The international carriers should also be permitted to own and operate their own earth stations. No effective competition with Comsat will be possible as long as it has a built-in advantage resulting from its space segment monopoly and control of the U.S. earth stations.

Requiring Comsat to form a separate retail subsidiary by itself is not sufficient to remedy the anticompetitive problems posed by Comsat's monopoly.

- The possibility of cross-subsidization will still exist, since Comsat's retail subsidiary could sell with little or no markup and still make an overall profit for the Comsat enterprise.
- A true measure of Comsat's competitive performance will not be achieved since Comsat will be charging tariff rates, including its full markup, both to its subsidiary and the international carriers.
- Large users, such as the U.S. government, will attempt to deal directly with the Comsat parent to avoid the retail subsidiary markup. This could result in garnering by Comsat of the most profitable business.

The FCC has also proposed to re-examine the long-standing restriction on AT&T's provision of international record communications services, with a view toward allowing AT&T to offer such services generally through its monopoly telephone arm. What the FCC is proposing, we submit, will not enhance competition in this market, but ultimately could destroy it. Introducing "competition" by a company with the advantages of AT&T will inevitably result in a major diversion of revenues from the competitive to the monopoly sector.

The Department of Justice has urged that restructuring of AT&T take place before AT&T is allowed to serve competitive markets such as ours. In April of this year, Assistant Attorney General Baxter stated that "AT&T should be kept out...of all potentially unregulated activities, until the Company's regulated [monopoly] activities are separated from its unregulated activities." As new markets, including ours, are becoming increasingly deregulated, full separation of AT&T's monopoly and competitive activities should precede its expansion in the competitive sector.

The history of the ten-year struggle of MCI and others to make limited penetration of the domestic interstate voice market is persuasive evidence that regulation alone is insufficient to deal with AT&T's economic power.

In sum, AT&T and Comsat entry would accentuate the need for pro-competitive safeguards presented by Western Union's entry alone.

Conclusion

Immediate and unconditional repeal of Section 222 will cause the serious anticompetitive consequences that I have outlined above unless adequate safeguards are adopted.

Although the FCC has the power to ensure fair competition by Western Union, it will not necessarily do so on a timely basis, as witnessed by its inaction on our application for domestic telex, its failure to resolve the five-year-old domestic interconnection rulemaking, and the fact that it took four years to find that Western Union had unlawfully failed to provide us with interconnection in two gateway cities. Therefore, we believe it is critical that specific guidance be given by Congress to guard against the anticompetitive consequences of Western Union's re-entry into international operations. This is imperative because the FCC has in the past apparently seen little difference between monpolists and other carriers in pursuing its policy of adding competition into selective markets.

If the Congress is to repeal Section 222, then the Congress must take active and meaningful precautions to ensure that such amendment will not cause the very anticompetitive consequences it seeks to avoid. The approach taken by S.1159 would provide the necessary safeguards by linking Western Union's entry into the international sphere to loss of its domestic dominance. Alternatively, the potential for anticompetitive consequences involved in a repeal of Section 222 can be curbed by legislation that would:

- Assure that the FCC grants international carriers immediate domestic operating authority;
- Provide for full and fair interconnection with Western Union for both domestic and international service; and,
- Provide for a three-year transition period that will afford the international carriers an opportunity to overcome the head start given to Western Union by virtue of its 38-year monopoly, thereby enabling them to establish a domestic network and build a customer base in the domestic market.

Thank you.

INTRODUCTION OF WITNESSES

Senator SPECTER. Our next panel consists of Mr. Ronald Coleman, legislative counsel, TRT Telecommunications Corp.; Mr. Stanford Weinstein, counsel for regulatory affairs, Graphnet; and Mr. Roger Newell, counsel, FTC Commmunications.

Mr. Newell and Mr. Coleman, we appreciate your submission of statements. Mr. Weinstein, we thank you for the outline. We would appreciate it if you would submit a full written statement.

We would like to start with Mr. Coleman. Noting that your full statement will be made a part of the record following the oral presentation of the panel, in accordance with our practice, we would appreciate it if you would summarize your statement.

STATEMENT OF RONALD COLEMAN, LEGISLATIVE COUNSEL, TRT TELECOMMUNICATIONS CORPORATION, WASHINGTON, D.C.; ACCOMPANIED BY ALLEN GANSCHOW, VICE PRESIDENT OF OPERATIONS

Mr. COLEMAN. Thank you, Senator.

My name is Ron Coleman. I am legislative counsel to TRT Telecommunications Corp. We very much appreciate the opportunity to share with you today——

Senator SPECTER. Excuse me. We have a fourth gentleman on the panel whom I have not identified.

Mr. WEINSTEIN. Yes, sir. This is Al Ganschow, who is with me from Graphnet. He is the vice president of operations. I wanted him to be at the table with me. I wanted him to be at the table perhaps to answer some questions.

Senator SPECTER. That is fine. Mr. Coleman?

Mr. COLEMAN. As I was saying, we very much appreciate the opportunity to share with you today the views of TRT regarding competition and industry structure in the telecommunications record services market.

Mr. Chairman and members of the committee, my name is Ronald D. Coleman. I am legislative counsel to TRT Telecommunications Corp. I appreciate the opportunity to share with you the views of TRT regarding competition in the telecommunications record services market.

TRT strongly supports the concept of a competitive environment for both domestic and international telecommunications. Indeed, recent procompetitive policies of the Federal Communications Commission have permitted TRT to grow from 1972, when it was a small regional carrier principally serving Latin America and generating less than 2 percent of the U.S. originated telex traffic, to today where we generate approximately 10 percent of the U.S. orginated traffic. By implementing substantial rate reductions and improved levels of service, TRT has been able to increase dramatically its market share. Since no IRC currently has the ability to control the access of another IRC to its customers, TRT has been able to compete effectively with companies the size of ITT, RCA and WUI. However, allowing Western Union to provide unlimited international telecommunications services, in conjunction with its dominant position in domestic Telex and TWX, would be an anticompetitive measure. In fact, Western Union's sudden entry into the international telecommunications market would dismantle the competitive advances that companies such as TRT have made over the past several years.

The provision by Western Union of unlimited international telecommunications services and the repeal of section 222 of the Communications Act raise fundamental antitrust concerns. Section 222 was enacted in 1943 as a result of the merger of Western Union and Postal Telegraph Co., the two companies the providing domestic telegraph services in the United States. Because of the concern that the merged entity would utilize its monopoly position in the domestic telegraph market to favor unfairly its own international telecommunications operations, Congress required Western Union to divest its international telecommunications services. In fact, Western union did not divest its international operations until 1963, and at that time agreed not to reenter the international market until 1988.

The Senate Committee on Commerce, Science, and Technology recently reported S. 271, which would repeal section 222, thus permitting Western Union to enter freely the international record communications market. S. 271, however, fails to provide any procompetitive safeguards to protect international telecommunications users and IRC's from the diminishing competition which will result following Western Union's entry into the international market.

S. 271 appears to be based on the premise that Western Union no longer has a monopoly over domestic record services. However, Western Union's domestic monopoly is far from over. It is still the dominant provider of domestic record services and controls most outbount international traffic delivered to the IRC's for overseas transmissionl. The FCC in its first report and order in CC Docket 79-252 recently concluded that Western Union has a "dominant carrier" due in part to its de facto monopoly in domestic Telex and TWX service. As recently as January 16, 1981, the FCC stated, in such proceeding, that:

> The public switched record submarket consists almost entirely of Western Union's Telex/TWX service. Since AT&T discontinued TWX service in 1971 and sold some of the associated facilities to Western Union, Western Union has maintained virtually a 100-percent share of this market. Recent entry by Graphnet into the market has had no noticeable effect on Western Union's performance.

In the absence of adequate safeguards, Western Union, upon repeal of section 222, would be able to divert the vast majority of the international traffic generated by the terminals connected to the domestic Telex/TWX network to its international facilities, thereby depriving TRT and the other IRC's of the opportunity to compete for that traffic. Western Union's expansive domestic network consists of approximately 140,000 Telex and TWX machines and a domestic satellite position: thus Western Union occupies a classic bottleneck position: the majority of international record traffic must pass through Western Union's facilities on its way overseas.

Western Union could commence international operations and monopolize such record traffic to most points in the world, immediately upon the effective date of S. 271. In this regard, it should be recognized that Western Union would need an operating agreement with only one foreign correspondent to commence widescale international services. Under existing international telecommunications arrangements, once Western Union has established operations with a single foreign correspondent, it could transmit all of its traffic to that correspondent for subsequent transmission to administrations around the world.

In stark contrast, it would take the smaller IRC's, such as TRT, years to establish domestic Telex facilities at a level competitive with that of Western Union. The argument has been made that Western Union's market dominance is rapidly disappearing, and that the FCC has authorized the IRC's to operate in additional gateways it would only be fair to allow Western Union to provide international services in competition with the IRC's. The IRC's, however, have been allowed to operate in additional U.S. gateway cities for less than a year. Western Union, on the other hand, has expanded its domestic monopoly over a 38-year period under the protection of section 222 and FCC policies.

More importantly, TRT and the other IRC's are not currently authorized to provide domestic record services in competition with Western Union. The FCC has merely authorized the IRC's to provide their international services directly to the public in additional U.S. cities. Even if the FCC should eventually authorize the IRC's to provide domestic transmission between their relatively few subscribers, none of the IRC's could hope to establish a meaningful, fully competitive alternative to Western Union's 140,000 subscriber, domestic network for some time. The IRC's for the foreseeable future, will have the opportunity to compete only for the business of users whose international requirements are sufficiently large enough to justify the expense of a separate Telex machine and Tieline dedicated exclusively to the transmission of international messages. Nearly all IRC subscribers will continue to require a Western Union terminal for their domestic messages. Moreover, the majority of Western Union's Telex and TWX subscribers do not have sufficient international message requirements to justify the installation of a dedicated international terminal and must therefore continue to transmit even their international traffic via Western Union.

To insure competition in the international telecommunications market, TRT supports legislation that would direct the FCC to find that a domestic record carrier is "not dominant" prior to permitting such carrier to engage in international record services. Rather than proposing an arbitrary moratorium, TRT believes that Western Union's entry into the international record market should be subject to adequate safeguards against monopolization and other anticompetitive practices. A dominant carrier should therefore be defined as a carrier that (1) engages in domestic telegraph operations in a substantial percentage of the total number of markets for domestic telegraph service, and (2) has the ability to either raise or lower prices in such markets without significantly affecting the demand for its services.

For the above reasons, TRT supports S. 1159, which would effectively prohibit Western Union from providing international record services so long as it possessed a 60 percent or greater market share for domestic record services. Under S. 1159, Western Union would be able to commence international record services as soon as the carrier demonstrates that it will not abuse its control of domestic facilities to gain an unfair advantage over the IRC's.

Finally, TRT would like to discuss briefly S. 898, the Telecommunications Competition and Deregulation Act of 1981, which the Judiciary Committee has recently sought referral. S. 898, from TRT's perspective, raises multiple antitrust-related concerns. It would appear that S. 898 was drafted with little sensitivity to the statutory framework proposed in S. 271. According to the report accompanying S. 271, the rational underlying the repeal of section 222 was that the FCC had ample authority under other sections of the 1934 act to prevent Western Union from engaging in cross-subsidization and other anticompetitive practices. S. 898, however, materially amends the 1934 act and eliminates what little protection those sections of the act afforded TRT. In the absence of the existing statutory framework, the FCC, for example, could no longer rely on section 214 to impose conditions on any Western Union authorization for the provision of international record services.

Under the carrier classification scheme of S. 898, it would appear that Western Union would not be classified as a dominant regulated carrier, or even a regulated carrier. Considering that the primary purpose of S. 898 is to foster competition in the domestic telecommunications industry, the classification of Western Union—a well recognized monopoly carrier—as an unregulated carrier is contrary to the expressed policies of the act. As an unregulated carrier, Western Union would be essentially free from rate regulation and would not be required to provide interconnection to other carriers or to customer premises equipment. TRT welcomes careful consideration of these issues by the Senate.

TRT does very strongly support the concept of a competitive environment for both domestic and international telecommunications. Indeed, procompetitive policies of the FCC have permitted TRT to grow from 1972, at a point when it was generating less than 2 percent of the U.S.-originated telex traffic, to today at a point where it generates approximately 10 percent of the U.S.-originated traffic.

Since no other IRC currently has the ability to control the access of other IRCs to its customers, TRT has been able to compete effectively with companies the size of ITT, RCA, and WUI. However, allowing Western Union to provide unlimited international telecommunication services in conjunction with its dominant position in domestic telex and TWX would be an anticompetitive measure. In fact, Western Union's sudden entry into the international telecommunications market would dismantle the competitive advances that companies such as TRT have made over the past several years.

Senator SPECTER. What are those advances, in brief, Mr. Coleman?

Mr. COLEMAN. I would like to provide for the record a history of TRT rate reductions in international telex services. TRT believes it has been a pioneer and leader in reducing international rates for those services.

The principle telex rate reductions initiated by TRT in recent years are as follows:

1. The establishment of a $.55 per minute reductions on an experimental basis for telex calls during off-peak hours to the United Kingdom and the Federal Republic of Germany (Transmittal No. 684; effective May 1, 1975).
2. The establishment of billing in 10th of a minute as opposed to full minute increments—equivalent to approximately a 15 percent rate reduction—for telex calls to Puerto Rico (Transmittal No. 694; effective November 1, 1975).
3. Established a $.55 per minute rate reduction for all telex calls to the United Kingdom (Transmittal No. 698; effective January, 1976).
4. The establishment of across-the-board reductions in its rates for its telex and leased channel services to the public. This filing was made in response to the FCC's prescription of reductions in Comsat's rates for satellite channels after a rate case. Over 150 percent of TRT's savings in cost for satellite facilities were flowed through to its customers (Transmittal No. 821; effective December 27, 1978).

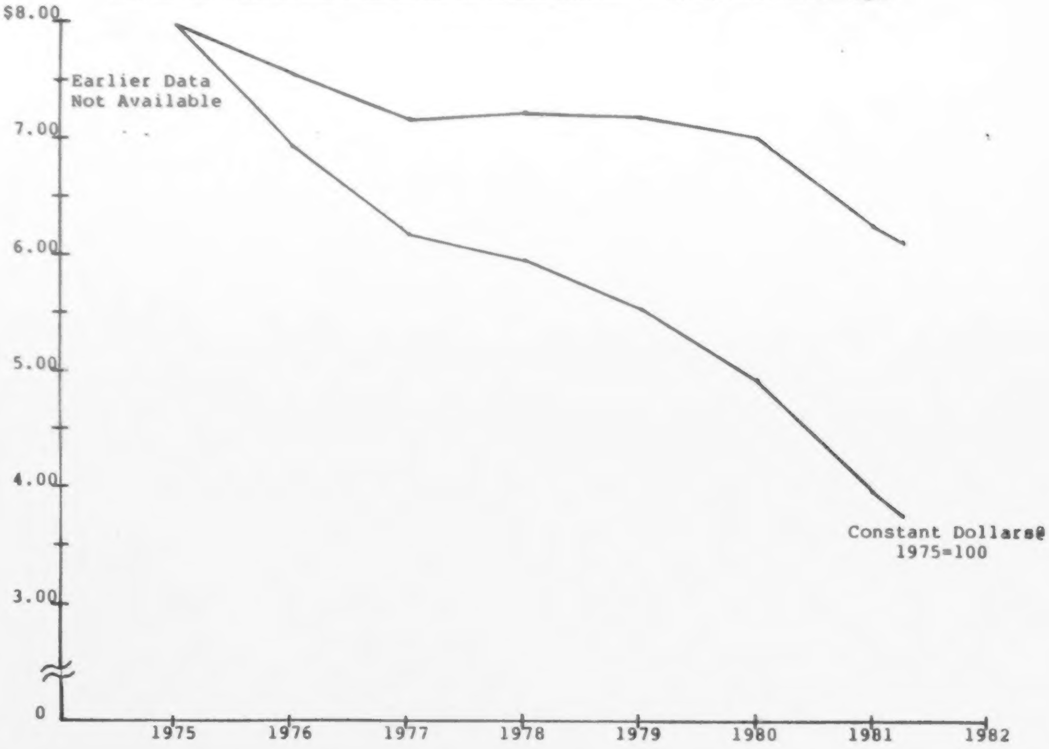
The net impact of these and other reductions in TRT's rates since 1975 on the average cost of an international telex call is illustrated in the attached chart. As shown the average cost to the consumer for an international telex call via TRT has been reduced from $8 in 1975 to $6.14 today. It should be recognized that this record of rate reductions was achieved in spite of the general inflation of prices, as also illustrated in the attached chart the reductions implemented by TRT have been even more dramatic in terms of constant dollars which reflect the impact of inflation. In this prospective, the $8 cost of a telex call in 1975 has more realistically been reduced to the equivalent of $3.76 in terms of constant 1975 value dollars.

For your information, I have also attached a similar chart illustrating the impact of the reductions in the prices for leased channel services which have been implemented in recent years.

[The charts follow:]

TRT TELECOMMUNICATIONS CORPORATION

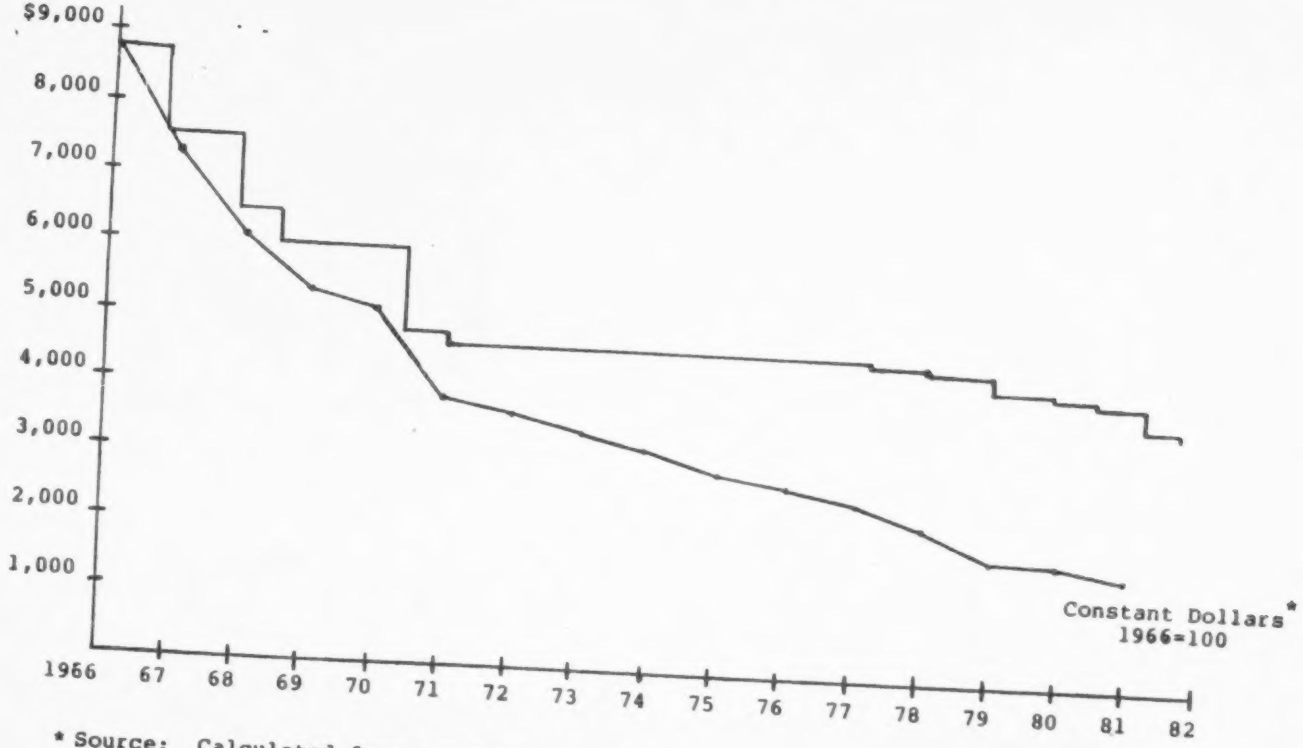
AVERAGE TRT GROSS REVENUE PER MESSAGE SENT - OUTBOUND TELEX CALLS */



*Source: TRT Job Order #85 Statistics
@Source: Calculated from GNP Deflator, U.S. Bureau of Economic Analysis

Average length of calls remained static during period at approximately 2 minutes and 42 seconds

TRT TELECOMMUNICATIONS CORPORATION
TRT VOICE GRADE LEASED CHANNEL RATES PER MONTH
EAST COAST TO GERMANY



* Source: Calculated from GNP Deflator, U.S. Bureau of Economic Analysis

Mr. Coleman. The provision by Western Union of unlimited international telecommunication services and the repeal of section 222 of the Communications Act we believe raise fundamental antitrust concerns. As was indicated earlier today, section 222 was enacted in 1943 as a result of a merger of Western Union and Postal Telegraph Co., the two companies then providing domestic telegraph service in the United States.

Because of the concern that the merged entity would utilize its monopoly position in the domestic telegraph market to favor unfairly its own international operations, Congress required Western Union to divest their international service operations. But, in fact, Western Union did not divest its international operations until 1963. At that time it did not re-enter the international market until 1988.

Senator Specter. Why did it take so long to compel Western Union to divest itself of its international operations?

Mr. Coleman. I do not know, Senator. I believe that Western Union and perhaps Western Union International could best address that question.

S. 271 appears to be based on the premise that Western Union no longer has a monopoly over domestic record services. However, as you heard, Western Union's domestic monopoly is far from over. In the absence of adequate safeguards, Western Union upon repeal of section 222 would be able to divert the vast majority of international traffic generated by the terminals connected to its domestic telex/TWX network to its international facilities, thereby depriving TRT and the other IRCs of the opportunity to compete for that traffic. Western Union's expansive domestic network consists of approximately 140,000 telex and TWX machines and a domestic satellite system.

Western Union could commence international operations and monopolize such record traffic to most points in the world immediately upon the effective date of S. 271. In this regard it should be recognized that Western Union would need an operating agreement with only one foreign correspondent to commence widescale international services.

Under existing international telecommunications arrangements, once Western Union has established operations with a single foreign correspondent, it could transmit all of its traffic to that correspondent for subsequent retransmission to other countries. In stark contrast, it would take smaller IRCs years to establish domestic telex facilities at a level competitive of that of Western Union.

To insure competition in the international telecommunications market, TRT supports legislation that would direct the FCC to find that a domestic record carrier is not dominant prior to permitting such carrier to engage in international record services. Rather than proposing an arbitrary mortorium period, TRT believes that Western Union's entry into the international record market should be subject to adequate safeguards against monopolization and other anticompetitive practices.

A dominant carrier, therefore, should be defined as a carrier that engages in domestic telegraph operations in a substantial percentage of the total number of markets for domestic telegraph service and, two, has the ability to either raise or lower prices in such markets without significantly affecting the demand for its services.

For the above reasons, TRT supports S. 1159, which would effectively prohibit Western Union from providing international record services so long as it possessed a 60 percent or greater market share for domestic record services.

Under S. 1159, Western Union would be able to commence international record services as soon as the carrier demonstrates that it will not abuse its control of domestic facilities to gain an unfair advantage over the IRC's.

Senator SPECTER. How would it make that demonstration?

Mr. COLEMAN. At the point at which, under such legislative provision, the FCC determines that its market share is below the dominant——

Senator SPECTER. It would just be a mathematical computation?

Mr. COLEMAN. That is right.

Finally, we would like to discuss briefly S. 898, the Telecommunications Competition and Deregulation Act of 1981, which your committee has recently sought referral. S. 898 from TRT's perspective raises mutiple antitrust-related concerns. It would appear that S. 898 was drafted with little sensitivity to the statutory framework proposed in S. 271.

According to the report accompanying S. 271, the rationale underlying the repeal of section 222 was that the FCC had ample authority under other sections of the 1934 act to prevent Western Union from engaging in cross-subsidization and other anticompetitive practices. S. 898, however, materially amends the 1934 act and eliminates what little protection those sections of the act afforded TRT. In the absence of the existing statutory framework, the FCC, for example, could no longer rely on section 214 to impose conditions on any Western Union authorization for the provision of international record services.

Under the classification scheme of carriers under S. 898, it would appear that Western Union would not be classified as a dominant regulated carrier, or even a regulated carrier. Considering that the primary purpose of S. 898 is to foster competition in the domestic telecommunications industry, the classification of Western Union—a well-recognized monopoly carrier—as an unregulated carrier is contrary to the expressed purposes in that act.

As an unregulated carrier, Western Union would be essentially free from rate regulation and would not be required to provide interconnection to other carriers or to customer premises equipment. TRT, therefore, welcomes careful consideration of these issues by the Senate.

We thank you for the opportunity to testify.

Senator SPECTER. Thank you very much, Mr. Coleman. We appreciate your testimony.

Mr. Weinstein?

STATEMENT OF STANFORD WEINSTEIN, COUNSEL FOR REGULATORY AFFAIRS, GRAPHNET, WASHINGTON, D.C.

Mr. WEINSTEIN. Thank you, Mr. Chairman.

I will be using the outline which has been distributed to you for the purpose of making my remarks this morning rather than a prepared statement.

In the interest of time, however, I will skip over some of the items in the outline because I believe they have already been adequately covered by previous witnesses.

WESTERN UNION'S MONOPOLY CONTROL OF DOMESTIC MARKET

I would like to start, however, by at least emphasizing one or two points which have been made by earlier witnesses. This goes to the point of Western Union's control over the domestic record marketplace.

As we have already been informed, Western Union does in fact control 100 percent of the domestic record marketplace.

Senator SPECTER. Mr. Weinstein, I think that point has been amply covered.

Mr. WEINSTEIN. Yes; it has, sir.

One of the things that has not been mentioned, however——

Senator SPECTER. One of the witnesses down the line is Mr. Richard Hostetler, executive vice president of Western Union Corp.

Senator Mathias is scheduled to return momentarily and I must leave to fulfil other commitments. I would be very interested to hear Mr. Hostetler in the light of what has been said. I do not wish to shortcut anything you have to say, but I would appreciate it if you would cover new ground.

Mr. WEINSTEIN. All right, sir.

One of the items which has not been mentioned this morning—in fact no mention whatsoever has been made of it—is Mailgram service. I only wish to mention that among the various services which Western Union has a monopoly over, Mailgram is one. That is of particular significance because in Mailgram service, Western Union has joined in a partnership with an agency of the U.S. Government, an agency which has in fact on numerous occasions refused to interconnect with Graphnet so that Graphnet could provide a Mailgram-type service of its own.

Senator SPECTER. What reason, if any, has been given for its refusal?

Mr. WEINSTEIN. No reason whatsoever, sir. They have merely refused to offer us the same types of interconnection, using that in its broadest sense, as they do Western Union.

WESTERN UNION'S ANTICOMPETITIVE PRICING PRACTICES

Taking Western Union's dominant market position as a given, I would like to move on to the second part of my remarks, which is that Western Union's domestic policies have evidenced an intent to monopolize the market.

First of all, Western Union has recently introduced a new rate structure for its telex/TWX exchange services. This rate structure is known as a postalized rate structure. It went into effect approximately 1 month ago.

Under this new postalized rate structure it is impossible, or nearly impossible, for a competing carrier to economically interconnect with Western Union. As you know, it is imperative that new carriers entering the marketplace interconnect with the systems of the existing carriers.

For example, in the voice communications market we now have competition with A.T. & T. by such companies as MCI and Southern Pacific. Were it not for their ability to interconnect with A.T. & T. on a local level, they would not be able to serve any customers whatsoever unless they were to try to establish a communications network of their own from scratch, on which there were no other customers.

I do not like to read statements, however, I would like to read two paragraphs to you which I have prepared on postalized rates per se, so that I can better explain to you why a postalized rate structure has a negative impact on competition.

Senator **Specter**. That is fine.

Mr. **Weinstein**. As I mentioned, for a new competitor to enter the marketplace it must interconnect with the existing communications companies' network services. If the rates for Western Union's local service are the same as the rates for Western Union's long haul services, as they are under postalized rates, then no customer will have an incentive to access one of Western Union's competitors via telex to send a message over the competitor's network.

The reason for this is that under a postalized rate structure the charge to the customer for dialing into the competitor's network, even if it is a local call, is exactly the same as the charge for completing the entire call to the designated party over the telex network.

If you compare the Western Union telex network to A.T. & T.'s telephone network, the effects of a postalized rate structure become even more apparent.

Senator **Specter**. Excuse me, Mr. Weinstein. We are going to have a substitution of chairmen. Senator Mathias will now preside.

Thank you, Senator Mathias.

Senator **Mathias** [acting chairman]. There are no monopolies on the Chair.

Senator **Specter**. Nor much competition. [Laughter.]

Senator **Mathias**. Gentleman, please proceed.

Mr. **Weinstein**. I was in the process of describing Western Union's new rate structure for its telex service, which is a postalized rate structure, and how it has anticompetitive impact on existing as well as future potential competitors in the record marketplace.

I was comparing Western Union's telex network to A.T. & T.'s telephone network, since they are functionally similar.

The postalized rate which Western Union is proposing would be comparable to A.T. & T. proposing to eliminate local exchange rates entirely while at the same time postalizing its interstate MTS rates, MTS being the normal long distance telephone service.

The result of such an A.T. & T. rate structure would be that the charge for a local call would be precisely the same as the rate for a transcontinental call. Imagine the effect that such a rate structure would have on A.T. & T.'s competitors, such as MCI and Southern Pacific.

Under such a proposal, an A.T. & T. customer in San Francisco could complete a call to New York for the same price as completing a local call. If this customer were to consider using the services of one of A.T. & T.'s competitors to complete the call to New York, he would quickly discover that the cost of dialing the competitor's local number would be precisely the same as the cost of completing the call to New York over A.T. & T.'s facilities. The only difference to the customer in using the competitor's service would be that, in addition to incurring the A.T. & T. charge, the customer would also incur the interstate charge of A.T. & T.'s competitor. Since it is necessary for a customer to use A.T. & T.'s local facilities to access A.T. & T.'s competitors, and since under a postalized rate structure that would cost the same as the entire interstate call, no customer would ever use the service of an A.T. & T. competitor.

Precisely the same situation exists in the switched record services marketplace. Thus, a postalized rate structure will immediately inhibit the business of existing competitors and will prevent the emergence of any new competitors.

The FCC's recent approval of Western Union's postalized rate structure sanctions the destruction of the very competition which it sought to establish.

Now there are a number of ways that monopolists can exhibit anticompetitive behavior. One is through pricing, and I have just mentioned the postalized rates.

As a specific example, recently Western Union offered to the international record carriers lower charges for the domestic handling of international telegrams only for those IRC's who do not give the traffic to Graphnet, Graphnet being Western Union's major competitor for the domestic delivery of international telegrams.

In addition to offering the IRC's lower rates if they do not use Graphnet, on March 6 of this year Western Union filed a tariff at the FCC which would apply a higher charge for any inbound international cablegrams which are turned over to Western Union by one of the IRC's after such messages have been previously furnished to Graphnet for delivery handling but returned to the IRC for refile with Western Union for ultimate delivery.

These increased charges only apply to those messages which an IRC had first given to Graphnet but, for one reason or another, Graphnet could not deliver the message and turned it back to the IRC. The IRC, making a second attempt to deliver it through Western Union now will incur substantially higher charges than if they had turned it over to Western Union in the first place. That is quite a penalty for using the services of a competitor.

WESTERN UNION'S ANTICOMPETITIVE INTERCONNECTION PRACTICES

In the communications area another way that a monopolist can exhibit anticompetitive behavior is in what we call interconnection. With respect to interconnection, for over 1 year Western Union has refused to fill Graphnet's orders for telex and TWX interconnection facilities.

In one instance an order was placed on June 3, 1980, for 434 telex lines and 192 TWX lines, and that order has still not been filled. This is a Graphnet order. In addition, orders for nearly 700 additional lines during calendar year 1981 are still on hold at

Western Union headquarters. A new competitor cannot operate without interconnecting with the existing established monopoly carrier.

Second, written requests by Graphnet to Western Union for trunk interconnection have gone unanswered. As a result, to the limited extent that we do interconnect with Western Union, we interconnect on a subscriber line basis; that is, we interconnect in the same fashion that any customer would receive service from Western Union. That is inefficient and costly for both Graphnet and Western Union.

In addition, Graphnet has requested so-called three-digit access codes. That is an abbreviated method of dialing instead of using a 7- or a 10-digit code as you would to make a telephone call. Graphnet has sought to get three-digit access codes from Western Union. We have been refused even though such codes are routinely granted to the IRC's.

Last, recently Western Union filed new interconnection tariffs with the FCC. While these tariffs appear to be some improvement over earlier versions which Western Union had filed and withdrawn at the FCC, nonetheless, even the current tariffs are restrictive and discriminate against carriers such as Graphnet.

OTHER WESTERN UNION ANTICOMPETITIVE PRACTICES

In other ways Western Union has also exhibited anticompetitive conduct. Western Union, because of its monopoly position over a 40-year period, has established and derived revenues from so-called cable code addresses. You see these on letterheads of major companies and law firms. These provide for immediate and direct routing to the recipient in the United States of inbound telegrams coming in from overseas.

In order to compete with Western Union, any competitor would need access to the cable codes and the addresses of the parties who have these cable codes. Western Union refused to turn these codes over to Graphnet. Only after Graphnet brought a complaint to the FCC and the FCC ruled in favor of Graphnet did Western Union finally turn over those codes to Graphnet.

Last, Western Union has also refused to turn over to Graphnet copies of its telex directory which it maintains on magnetic tape. Graphnet on several occasions has asked for these magnetic tape copies of the telex directory. We have been refused even though Western Union in fact gives this information routinely to the IRC's.

IMMEDIATE REPEAL OF SECTION 222 WILL HAVE ANTICOMPETITIVE CONSEQUENCES

I would like to move on now and make just a few brief comments about section 222.

If section 222 is repealed, Western Union will, as others have told us this morning, use its domestic monopoly power to take over the international marketplace. You must understand that for a carrier to enter the international marketplace there are two requirements. One is that it must be authorized by the FCC to provide the international service.

Second, because we are talking in international terms rather than domestic terms, the carrier must enter into operating agreements with foreign administrations in order to exchange traffic with the foreign countries.

The FCC authorization would be easily obtained by Western Union. In fact, it already received authorization once from the FCC, although that authorization was overturned by a recent court decision.

In addition, on the second point, Western Union will have no trouble negotiating operating agreements with foreign administrations because it can use its control over the domestic U.S. traffic as a bargaining chip. Foreign administrations will readily interconnect with the company on whose network all the traffic is generated. This will in fact allow the elimination of the so-called middleman, the IRC's which have testified here earlier today.

I want you to understand that Graphnet is not "crying wolf." Western Union does pose a real threat. As an example, when Western Union recently got into the international business before being stopped by the Court of Appeals, within 90 days of the commencement of its international telex service, Western Union was able to garner over 10 percent of the total outbound traffic generated on the domestic telex network. That is more than TRT, who has just spoken, has been able to muster in over two decades.

One reason for this is that Western Union has free advertising over its own network; that is to say, they send out advertisements over the telex network to everyone who has a telex machine hooked up to the network. In addition, they have used certain anticompetitive tools which we have already spoken about earlier today.

In conclusion, Western Union must not be allowed to enter into the international marketplace until both of the following two conditions are met:

First, Western Union's market share must drop to the point where it no longer has monopoly control over the marketplace. In S. 1159 I believe that the trigger point was set at a 60-percent market share. Graphnet would suggest that 50 percent of the market share would be a more appropriate trigger point.

Second, the United States must adopt a policy with an appropriate enforcement mechanism, which forces foreign administrations to enter into operating agreements with all FCC authorized carriers on an equal basis. There are two ways of accomplishing this.

One would be a so-called blanket operating agreement approach. Under that approach, any carrier that entered into an operating agreement with a foreign administration would be required to insure that that operating agreement is available to all competing carriers. That way a foreign administration would know that once it signs an agreement with one U.S. carrier, that agreement is applicable to all U.S. carriers.

Another approach would be what I call a single entity approach. That would require the establishment of a consortium or a Government-type organization similar, say, to Intelsat or Comsat where a single entity would represent all U.S. interests, and it would negotiate with foreign governments on behalf of all U.S. carriers. In that manner it would negotiate agreements which would foster effective competition in the marketplace and would not favor one carrier over another.

Thank you.

Senator MATHIAS. Mr. Newell?

STATEMENT OF ROGER NEWELL, VICE PRESIDENT AND GENERAL COUNSEL, FTC COMMUNICATIONS, NEW YORK, N.Y.

Mr. NEWELL. My name is Roger Newell. I am Vice President and General Counsel of FTC Communications, the smallest of the five international record carriers.

I would like to express my appreciation to the committee for the opportunity to appear before you today.

If some propaganda is mentioned, I would like to mention that we have been around for 102 years. We believe that we would not be able to survive the introduction of Western Union into the international record industry because it would involve the diversion of by far the majority of our revenues.

Senator MATHIAS. I note a pride in your voice that you have survived for 102 years. That would indicate that the company, FTC Communications, may occupy the same position in the communications world that Daniel Webster described for Dartmouth College. It was a small college but there were those who loved it.

Mr. NEWELL. Yes. Unfortunately, there are not enough of those who love FTC Communications.

Senator MATHIAS. All the world wants more lovers.

Mr. NEWELL. Yes. We are trying hard.

We very much support S. 1159 here for many of the reasons that have been covered adequately by other speakers this morning.

I would like to focus my remarks on one reason why and exactly how Western Union would be extremely damaging to competition in the international record industry if it were permitted to enter.

It is our position that if such entrance were permitted there could be no expansion of existing carriers and no new carriers could possibly enter into the field. I would like to explain exactly why that is so.

However, to do so I would have to go briefly into some of the business aspects of the industry, specifically the importance to an international record carrier of having direct relations with as many overseas telecommunications industries as possible.

There is a great importance to each international record carrier of having these international direct relations. Direct relations mean that the IRC in question connects directly with the overseas administration rather than going through a transit point with a third country. Communications which go through a third country require that the tolls for those communications be split three ways, whereas a communication directly to another country has its toll split only two ways. Therefore, there is more revenue to an IRC for a telex message to a direct connection country.

Second, where there is direct connection the overseas country will give the IRC inbound traffic, whereas where the connection is indirect that IRC would receive no inbound traffic. This inbound traffic provides considerable revenue and is the most useful portion of revenue because the traffic comes at offpeak periods and therefore does not require additional plant.

Finally, if a carrier does not have a multitude of overseas connections, it is not able to receive inbound traffic from a number of countries. The prime example of this is Japan. The Japanese telecommunications company will interconnect only with the big three IRC's and will not interconnect with the smaller IRC's such as FTC and TRT. As a result, a customer who has communications requirements with Japan will not take a teleprinter from TRT or FTC because he cannot receive inbound traffic from Japan.

Now if Western Union were to enter into the market, they would have enormous advantages over the IRC's in obtaining new agreements. The large three IRC's each have agreements with well over 100 countries. TRT has agreements with approximately 50 countries. FTC has agreements with only 10 countries.

If Western Union were to be allowed to go to the overseas countries and offer to interconnect, we believe that they would be able to make an offer to these overseas countries far more attractive than FTC or TRT or any other potential entrant into the field could possibly make.

Western Union would have very large negotiating power because they would control at least half of the outbound traffic from the United States. They would be able to go to a particular country and offer them direct connections, not only direct connections but offer to use that country as a transit point for third countries. Therefore, the overseas country would have much increased revenue by virtue of interconnecting with Western Union.

Additionally, it would be able to use a fewer number of facilities to interconnect with Western Union than with five or more IRC's. On this basis the overseas country would interconnect with Western Union and would have absolutely no incentive whatsoever to interconnect with FTC or with Graphnet or with any other company which desired to enter the international field.

As it is, many overseas communications companies, which are generally government monopolies, believe that there are far too many American companies. They are used to dealing with monopolies in other countries and not with this confusing array of domestic U.S. companies.

For that reason, we are very much opposed to the entry of Western Union to the field simply because it would close out everybody else.

We would like to note that, in addition to the many advantages that Western Union has domestically that have been noted due to their control of about 140,000 domestic telephone machines, they have many other advantages. Western Union now has well over 500 salesmen, far more than any IRC. It has the revenue to hire many more salesmen than that. It has exclusive control over the telex directory which is sent to each one of those 140,000 customers and could give its own international services preferential treatment in the directory.

Mr. Weinstein mentioned the free broadcast messages that Western Union can send without cost to its subscribers. I would like to point out that for an IRC to send a message to those 140,000 subscribers in the same way it would cost over $50,000 a minute. For Western Union the cost is free.

In conclusion, we believe that before Western Union should be permitted to provide international communications there should be certain preconditions placed on it. The most important is that there should be effective competition domestically. That competition can come from new telex companies or it could come from permission to the IRC's to provide domestic communications between their own subscribers and also between its subscribers and those of Western Union.

When Western Union has less than 60 or 70 percent of the domestic telex communications market, then its stranglehold over domestic communications would be greatly reduced and, therefore, the dangers associated with their going into the international field would also be considerably reduced.

For these reasons, we support the enactment of S. 1159.

Thank you, Senator.

Senator MATHIAS. Thank you very much.

Gentlemen, would you hold fast just a moment. I have a few questions for you.

One thing I wanted to get perfectly clear in my mind was this: In analogizing Western Union's situation to A.T. & T., it was testified that if A.T. & T. were to adopt the same rate policies which Western Union was adopting, that it would have the effect of making a local call the same rate as a transcontinental call. Is that correct?

Mr. WEINSTEIN. Yes, sir; that is correct.

Senator MATHIAS. That is a very dramatic analogy. I want to be sure that I have it firmly fixed in my mind.

Mr. WEINSTEIN. That is absolutely correct.

Senator MATHIAS. You stand on that?

Mr. WEINSTEIN. Oh, yes; absolutely. There is only one rate for telex calls. It does not matter what the distance is. You can be calling your next door neighbor and it would be the same price.

Senator MATHIAS. We are not transposing that and saying that the transcontinental call rate would be the same as the domestic rate?

Mr. WEINSTEIN. Yes; I am. I am saying that there is only one rate. I believe 34¾ cents per minute is the telex rate today. That is the only telex rate today. We are talking domestically now, not international.

Senator MATHIAS. That is right; we are talking only domestic.

Mr. WEINSTEIN. It does not matter what the distance traversed is—next door or across the country—it is the same price.

Senator MATHIAS. Let me ask Mr. Coleman a question here. In your written testimony it is stated that TRT generates approximately 10 percent of the U.S.-originated traffic. Again I want this fixed in my mind. Would this mean that even if Western Union were to enter the international market, that you would be competing with them only in 10 percent of your operations?

Mr. COLEMAN. No. We would be competing with Western Union in the entire international record market. The 10 percent figure is the percentage of the total U.S.-originated traffic carried by TRT. TRT competes for such traffic with Western Union International, ITT, RCA, and FTC. To the extent that TRT would be in competition with Western Union, it would be competing for a share of the entire market. We would expect that that market share would drastically decrease upon Western Union's entrance.

Senator **Mathias**. You also point out in your written statement that Western Union would need an operating agreement with only one foreign correspondent in order to begin very wide-scale international services.

I wonder whether you can expand on that a little bit.

Mr. **Coleman**. Certainly. As both Mr. Newell and Mr. Weinstein mentioned, in order to begin international operations one needs an international operating agreement with a foreign PTT. However, with that operating agreement, one may use that country as a transitting point to carry the traffic from that country to other countries with which the transitting country has operating agreements.

The benefit to the country acting as a transit point is that it derives a certain percentage of the total settlements for acting as a transit point. In fact, when TRT began its operations with an operating agreement with Italy, that is precisely how its initial traffic operations was distributed.

Senator **Mathias**. They really become just a funnel that expands very rapidly once you get through the neck of the funnel.

Mr. **Coleman**. The other country can become a funnel, yes, sir.

Senator **Mathias**. Mr. Newell, you referred in your testimony to the fact that some foreign carriers are reluctant to deal with any except the two or three largest of the American companies. Let me ask any of you whether you have encountered any difficulty in securing contracts to offer services to foreign countries, and what is the source of those difficulties if you have had them.

Mr. **Weinstein**. I would like to address that for Graphnet. Let me tell you just how difficult this really is.

The FCC authorized Graphnet to enter the international field as the first new international carrier in January of 1977. That was over the objection of the existing IRCs. The IRC's then appealed the FCC's decision to the court of appeals. The court of appeals affirmed but required the FCC to place a time limit on Graphnet's authorization during which time it should enter into an operating agreement with a foreign country. The time limit imposed was 3 years. During that 3-year period Graphnet was unable to enter into an operating agreement with any nation overseas. As a result, that FCC authorization expired unused.

Subsequently, Graphnet has filed for and been granted a new FCC authorization. We have entered into an operating agreement with the Republic of the Philippines and are now anticipating beginning international operations through the Philippines as the only country with which we have been able to enter into an operating agreement to date. We will use the Philippines, much as Mr. Coleman has described, as a funnel and as a transit point to serve other points around the world.

It has been very difficult. The Western European nations, to put it mildly, refused to speak to new carriers here.

Mr. **Newell**. Even though we are a long established carrier, we have met with considerable resistance from overseas administrations in obtaining direct connections.

The attitude in the overseas administrations, which, as I mentioned are Government bureaucracies for the most part, is that "We are able to get all our traffic to the United States through the carriers with whom we do have agreements. What do we need another one for? Every minute of telex which comes from the United States will get to us one way or another. We don't need you." Our response is, "If you sign with us we will send you some of our transit traffic."

This means, for example, that if we have traffic to a country in Africa where we do not have operating agreements and we do not expect to have operating agreements soon, we can go to a country with whom we wish to operate directly and say, "We will route all of our traffic to Africa through you if you give us an operating agreement."

Now that has had some success. We have increased the number of countries with which we have direct relations from two major ones, two important ones, to seven important ones and three other ones. However, it is not easy. You must have traffic to begin with in order to be able to persuade an overseas administration to interconnect with you so you can get more traffic.

Senator MATHIAS. I have one last question for any one of you on the panel.

If the economic consequences of unleashing Western Union are as you are predicting them to be here today, then there must be some reason that people would want to do business with Western Union. There must be some advantage that Western Union can offer.

What is the advantage that Western Union can offer in dealing with foreign administrations which would enable Western Union to secure contracts more easily than its competitors in the international communications field?

Mr. COLEMAN. Senator, briefly the answer from our perspective is Western Union's monopoly control over the domestic telex and TWX network; its 140,000 domestic subscribers, currently with Western Union equipment in place, who will immediately become Western Union subscribers for international service as well; and the fact that the foreign PTT's will be able to deal directly with Western Union.

An incentive to the PTT's to deal with Western Union will be their added ability to whipsaw the carriers on settlement reductions. The fact that Western Union controls as much of the traffic as it does certainly will give the PTT's more leverage in dealing with the smaller IRC's.

Mr. NEWELL. I would like to make that a little more concrete. Take the example I used just a minute ago. We could go to a European country and offer them 5,000 minutes a month of transit traffic to Africa. Western Union would be able to go in and offer them 500,000 minutes of transit traffic to Africa. After they do so, that country simply would not be interested in talking to an FTC or a Graphnet. We just do not have the kind of traffic which Western Union would be able to control.

Senator MATHIAS. Are there any further comments?

Mr. WEINSTEIN. I really have nothing to add. They have said it.

Senator **Mathias**. We thank you very much for being here today, for your testimony, for the benefit of your wisdom and experience which you have offered to the committee.

[Material follows:]

Testimony of Roger P. Newell
Before the Senate Committee on the Judiciary
June 10, 1981

My name is Roger P. Newell. I am Vice President and General Counsel of FTC Communications, Inc., an international record carrier. I would like to express my appreciation to the Committee for the opportunity to appear before you today.

Competition in the IRC Industry

The international record communications industry consists of three large carriers, two smaller carriers and a flock of potential entrants. The three large carriers, ITT World Communications Inc. (ITT), RCA Global Communications Inc. (RCA) and Western Union International, Inc. (WUI) dominate the industry. Together they carry about 90% of total traffic. As the smallest of the IRCs, with about 2% of the business, FTCC is strongly in favor of anything which would tend to increase competition to the Big Three. In light of the general tendency in Washington recently to focus on the marketplace as a substitute for regulation, an appealing argument has been made that Section 222 is anti-competitive, because it excludes a competitor from the international market. However this does not hold true when examined more closely. Western Union has such enormous advantages over even the largest IRC, let alone a small IRC such as FTC, that the end result of the repeal of Section 222 without proper safeguards would be to create either a monopoly in international record communications or at best a situation like that in the steel industry, where one large company dominates a few smaller ones. I believe that Congress' attention would be more wisely focused on domestic telex, where there is truly a monopoly, than on the international industry, where there is already vigorous competition.

The Importance of Direct Relations With Overseas Administrations

To appreciate the effect on the IRCs of Western Union's entry into the international record industry, it is necessary to understand the importance of direct relations between the United States record carriers and overseas communication administrations. The United States is virtually alone in having a highly competitive international record industry. Almost without exception, in other countries this service is provided by a monopoly, usually either government-owned or a branch of the government. These administrations are used to dealing with a single unified administration in other countries for all telecommunication purposes. When they deal with the United States, however, these governmental bureaucracies have to face several competing IRCs. The multiplicity of carriers seems to them to be more of a nuisance than a benefit.

Each administration is at liberty to agree to or refuse to interconnect with any particular United States IRC. Many countries refuse to deal with all U.S. IRCs. For example, Japan, the second largest telex market in the world, refuses to interconnect with any IRC other than the Big Three. Yet it is vital to the interest of each IRC, large or small, to interconnect directly with as many overseas administrations as possible.

The importance to an IRC of having many direct relations is threefold. In the first place, the IRC retains more revenue for telex and telegram traffic sent directly than for traffic sent on an indirect basis via a transit country. The tolls for direct traffic are split two ways, while the tolls for transit traffic must be split three ways. Additionally the indirect route often creates delays, or interference with transmissions, leading to poor service.

Second, if an IRC does not have direct relations with a particular overseas country, it will not receive any inbound traffic from that country. Inbound traffic is the most profitable form of traffic, since it does not require any additional plant, and usually comes at offpeak hours due to time zone differences between the United States and Europe and Asia. The amount of inbound traffic that is allocated to each IRC by a particular country is dependent on the proportion of the total outbound U.S. traffic to that country carried by that carrier. Thus the more outbound traffic a carrier handles, the more inbound traffic it will receive. Inbound traffic revenue can be used to finance sales forces and marketing efforts, which in turn generate more outbound traffic. Therefore, if a carrier cannot receive inbound traffic, it is deprived of revenue from both directions.

Third, if a carrier cannot receive inbound traffic from most of the world, its attractiveness to the marketplace is considerably reduced. For example, if a carrier cannot receive inbound traffic from Japan, a customer which has regular dealings with Japan will not make the investment in a teleprinter and tieline to take that carrier's services. Therefore a wide range of overseas direct relationships is absolutely essential for the viability of a competitor in this industry. The big three IRCs each have direct relations with well over 100 countries, including all the principal traffic points. TRT has direct relations with approximately 50 countries. FTCC presently has direct relations with only ten countries-- seven in Europe and three low volume countries in Africa.

FTCC is attempting to widen its network of overseas relationships, and has increased this number considerably since 1978 when it connected in Europe only with the United Kingdom and France. However it has met with considerable reluctance from overseas administrations. Most of these administrations already connect with four IRCs, and see no advantage to opening direct relations with a fifth carrier, especially one which has much less traffic to offer than the other IRCs. Since FTCC has a small percentage of the total outbound market, it has very little economic leverage. Nevertheless, through careful allocation of the transit traffic at its disposal, FTCC is slowly but steadily expanding its range of relationships.

The Effect of Western Union's Entry

If Western Union were to be permitted to enter the international record field, a difficult situation would become impossible for a carrier such as FTCC which seeks to challenge the Big Three carriers. Because of its inherent advantages, Western Union would be able to obtain direct relations with overseas administrations around the world without difficulty. In the process, it would shut the door forever on the possibility of FTCC or any other new or expanding carrier to obtain direct relations.

Western Union's enormous advantages over the IRCs, especially the smaller ones such as FTCC, stem directly from its monopoly control over the domestic telex industry. Western Union has used the almost 40-year monopoly granted to it by the FCC to build a network of 140,000 domestic teleprinter subscribers. 65% of all international telex business is with these Western Union subscribers. After Western Union has its own international service, it could use its unique ability to reach its own subscribers at little costs to divert a majority of this traffic to its own overseas service. Western Union would then be able to approach overseas administrations individually, and offer each direct relations, possibly with more advantageous financial terms, and in addition offer to route transit traffic to third countries via each of the major traffic centers around the world. The combination of greater toll retentions for direct traffic, and the promise of large volumes of transit traffic destined to third countries, would make Western Union's offer of direct relations very attractive. When Western Union points out that its high volume of traffic derived from its domestic monopoly would permit more intensive use of transmission lines, its offer would be virtually irresistible. Inevitably, most of the major administrations around the world would sign up with Western Union. Then Western Union would argue that since it provides service to the majority of U.S. telex users, there would be no need for intermediary companies such the IRCs. FTCC would be in a position of requesting not merely to be the fifth United States record carrier, which is difficult enough, but the sixth, and with a tiny fraction of the volume offered by Western Union. It is highly unlikely that FTCC would obtain any more international agreements after Western Union is unleashed. Its growth would be stopped dead in its tracks. Outbound traffic from Western Union's subscribers would be diverted; and inbound traffic from those countries with which FTCC has direct relations would be sharply reduced because FTCC's proportion of outbound traffic would drop.

The situation is as bad or worse for other potential entrants such as Graphnet, which has been seeking to become another international record carrier. Thus the effect of repealing Section 222 without safeguards would be to stifle any possibility of growth in the number of international record carriers.

Other Western Union Advantages

Beyond its ability to obtain direct relations, Western Union would have overwhelming marketing advantages over even the largest IRCs. For example it now has over 500 salesmen (according to reports filed with the FCC) which could be used to divert traffic from the IRCs, and the funds to hire many more. It has filed tariffs requiring the IRCs to pay exhorbitant charges for the right of access to its subscribers, while exempting itself from these charges. It can provide its subscribers access to its international switch at artificially low rates - or even free - while these subscribers would have to pay Western Union's full domestic telex rates to reach the switches of the IRCs. It can use these artificial cost differences to undercut the IRC's rates, relying on predatory pricing to drive the IRCs out of business. It can send broadcast telex messages advertising its international services to all of its 140,000 subscribers at no cost, while it would cost an IRC over $50,000 per minute for such a broadcast message. It would have the power to manipulate its system so that the quality of service for a subscriber trying to reach an IRC would be noticeably worse than for a subscriber wishing to use Western Union's international service. It has a name that everyone recognises. Its salesmen can point to the fact that a company that subscribes to its service can send and receive telex both domestically and internationally, while the subscriber to the IRCs' services can only communicate internationally.

Safeguards Are Necessary

All of these advantages spring from the monopoly that resulted from the antitrust exemption that Congress chose to award in 1943. Western Union has enjoyed nearly forty years of restraint of competition. The only price that it has had to pay is exclusion from the international market - a price that it chose of its own volition to pay. Western Union still has its domestic monopoly - a forty-year advantage is not overcome in a hurry. If Congress chooses to relieve Western Union of even this small price, it must in all fairness provide a measure of protection for other competitors from the misuse of the power derived from this 40 year monopoly.

In my view, Congress should place two protective preconditions on Western Union's entry into the international arena. First, the inability of the IRCs to provide their subscribers with domestic telex access should be corrected by requiring the FCC to order interconnection to Western Union's networks upon reasonable request and a finding that the public interest so requires.

Second, since the source of Western Union's advantage is its unquestioned domestic dominance, Congress should delay Western Union's entrance into the field until it ceases to be a dominant carrier. This point could be defined as the time when it has less than 70% of the domestic telex business. (The interconnection of the IRCs for domestic telex would provide much of the new competition needed to reach that point).

With these two safeguards, there would be reasonably fair competition, and the Congress could then expect a reasonable chance that Western Union's provision of international record services would increase rather than reduce competition.

INTRODUCTION OF WITNESSES

Senator **Mathias**. Our next witness will be Mr. Dale Hatfield, acting assistant secretary for communications and information, National Telecommunications and Information Administration.

STATEMENT OF DALE HATFIELD, ACTING ASSISTANT SECRETARY FOR COMMUNICATIONS AND INFORMATION, NATIONAL TELECOMMUNICATIONS AND INFORMATION ADMINISTRATION

Mr. **Hatfield**. Mr. Chairman, thank you very much for giving me the opportunity to express NTIA's views on the competitive issues in the international communications industry. Needless to say, the subject has continued to receive a great deal of attention at NTIA.

I think that because of the lateness of the hour and the earlier testimony I will try very briefly to summarize my points.

Senator **Mathias**. Your written statement will be included in the record as fully as if read at the conclusion of your oral presentation.

Mr. **Hatfield**. NTIA has consistently recommended regulatory and congressional action to foster greater competition in the provision of communication goods and services both domestically and internationally. International communications are especially important because of their vital role in the expansion of world trade.

Efficient development and more rapid innovation in the field of communications and data processing clearly result when artificial barriers to competition are eliminated. While some domestic consumers have already benefited from procompetitive initiatives, a number of restrictions still inhibit the extension of these competitive policies internationally. That is why we support legislation repealing section 222 of the 1934 Communications Act in order to eliminate one of these barriers. However, we are concerned about the potential for the lessening of competition, and that is why we have urged various safeguards to be included in any repeal legislation.

I will not repeat the discussion of the background of section 222. Is it set forth in my statement before the Senate Communications Subcommittee in February of this year.

Let me emphasize, however, the fact that since enactment of this provision of the 1934 act the phenomenal advances in the sophistication and variety of communication services have rendered the inflexible market restrictions of section 222 contrary to the public interest.

Domestically, Western Union faces competition from a number of carriers offering similar or substitutable services. Some of this competition is provided by the domestic companies associated with the international record carriers.

For example, the international record carriers themselves have filed applications to provide domestic services, in addition to expanding their international points of operations to more U.S. cities. We have urged, and we do urge, the FCC to act affirmatively upon these applications in the near future.

While it is important to eliminate section 222 as an artificial barrier to Western Union's entry into the international market, we recognize the importance of maintaining regulatory oversight to insure that Western Union does not act in an anticompetitve manner. Although Western Union no longer has the domestic record monopoly which was the quid pro quo for divestiture with international operations, it does have substantial control over the domestic telex/TWX facilities.

Thus, should its entry into the international market be found to be in the public interest, its entry must be accompanied by actions which insure appropriate and equitable access to those domestic facilities by competitors.

NTIA consistently has urged that language in any such bill—any bill to repeal section 222—address the responsibility of the FCC for insuring full and fair competition. Nondiscriminatory interconnection is a key element to a competitive environment after the repeal of section 222.

In addition, the FCC must assure the protection of the public interest not only in the case of interconnection but through the resolution of traffic distribution problems and other matters that may arise.

Under the current act the Commission has a number of remedies in its arsenal. One is to condition any authorization it might grant Western Union to require the firm to provide full and fair interconnection. This would be in the section 214 process.

In addition, other sections of the present act, notably section 201, provide a remedy for grievances concerning withholding of interconnection. Under this section a carrier may file a complaint, have the opportunity before a hearing, and receive redress if the Commission finds interconnection to be necessary or in the public interest.

Consequently, in our support for repeal of section 222 we have pointed out various remedies and we have supported as well a legislative mandate to the FCC to take whatever steps are necessary to insure full and fair competition. This would include equitable access and interconnection should it authorize Western Union to provide international service.

In summary, while we share your concerns about the potential for lessened competition, NTIA continues to support repeal of section 222 as an artificial barrier to increased competition. However, we agree that safeguards, including continued availability of antitrust sanctions, are necessary to insure that Western Union's entry into the international market does not have the potential for lessening, rather than increasing, competition.

Thank you.

Senator **Mathias**. Thank you, Mr. Hatfield.

In your statement before the Commerce Committee when they were exploring the provision of S. 271, you expressed some concern over the difficulties experienced by the IRC's seeking interconnections with Western Union in the past. You stated at that time that your concern would be ameliorated by broader statutory language that was accompanied by legislative history indicating congressional intent that this broad mandate includes FCC consideration of the problems of interconnections, traffic routing, and possible anticompetitive actions of Western Union.

Do you recall making such a statement?

Mr. HATFIELD. Yes, sir.

Senator MATHIAS. What did you have in mind? What type of statutory language were you thinking about?

Mr. HATFIELD. I do not have that statement in front of me. However, as I recall, there was proposed additional language that we actually suggested in that statement which would direct the FCC, before it granted the 214 authorizing the international service, to condition that 214 upon Western Union's providing full interconnection.

Senator MATHIAS. This really implies then the concern that you have about the development of a monopoly in this area.

Mr. HATFIELD. Yes. Let me explain. I think that is entirely consistent with what I am saying here; that is, Western Union still does have some market power, and in view of that, before the Commission makes the public interest finding that they should be an international market, they should condition their 214 in some way so that they have provided interconnection. They must provide interconnection.

Senator MATHIAS. Is it your judgment that the proposal which has been raised by some people of a 6-month to 1-year phase-in period during which the international record carriers would be permitted to enter the domestic market before Western Union begins to operate in the international market, would be a useful or an appropriate response to this kind of situation?

Mr. HATFIELD. Let me say that I think there will be a natural phase-in time anyway. It will take the Commission a while to go through the procedure to grant the 214. In fact, this whole legislative process, of course, has served notice to the international record carriers that the situation is changing.

What I am saying is that the natural phasein period would occur as a result of the ordinary Commission's process.

Senator MATHIAS. What is known by the general public as bureaucratic delay.

Mr. HATFIELD. Right. Exactly.

On the other hand, I would hasten to add that I do not think we would have any objection to a statutorily imposed moratorium of some reasonable length.

Senator MATHIAS. A legislative delay which would mask the bureaucratic delay.

Mr. HATFIELD. Yes.

Senator MATHIAS. Are you familiar with S. 898, which has been called the telecommunications competition and deregulation bill of 1981?

Mr. HATFIELD. We are studying that bill at the present time, Senator. I am not prepared today to comment on it very specifically.

Senator **Mathias**. I have just one question in connection with it. There is a provision in that legislation which states that upon notification to the Commission, any regulated carrier which is not also a dominant regulated carrier may undertake the construction of any new interchange transmission facilities or of any extension thereof, or to require or operate any such facility or extension thereof, or engage in telecommunications over and by means of such new facilities or extension.

I do not want to ask you to make a commitment that you are not ready to make, but you might advise us when you have completed your study of that legislation whether you believe passage of this section would significantly impair the ability of the FCC to address the concerns of the public or of potential competitors or of existing competitors, which the Commerce Committee report states can and must be addressed in the context of procedures under section 214.

If you can let us have your view on that, it would be helpful.

Mr. **Hatfield**. The issue basically is whether that applies to international facilities or not.

Senator **Mathias**. Thank you very much for your appearance, unless you have anything further to add.

Mr. **Hatfield**. No, sir. Thank you.

Senator **Mathias**. Our next witness will be Mr. Richard C. Hostetler, the executive vice president of Western Union Corp.

STATEMENT OF RICHARD C. HOSTETLER, EXECUTIVE VICE PRESIDENT, WESTERN UNION CORP., ACCOMPANIED BY JOEL YOHALEM, VICE PRESIDENT AND GENERAL SOLICITOR

Mr. **Hostetler**. Thank you, Mr. Chairman, for the opportunity to appear here this morning.

I am accompanied by Joel Yohalem, who is our vice president and general solicitor and on whom I may call to assist with the answers to any questions.

Senator **Mathias**. It is a pleasure to welcome him as well as having you with us here this morning.

Mr. **Hostetler**. Thank you, sir.

I did not have the opportunity to prepare any written comments, though I will be happy to supplement whatever I have to say in any fashion that you may find useful.

Senator **Mathias**. I will direct that the record remain open so that you have that privilege.

Mr. **Hostetler**. Thank you.

I might say that those of us who are here this morning have been engaging in this kind of very intense discussion for the past 4 years before a number of congressional panels. It was my expectation that I would find inspiration in what was said previously, and, indeed, I could go on at length.

Senator **Mathias**. I have been sitting in this room for a good many years. There have been inspiring moments, but not very many.

Mr. **Hostetler**. I might say not particularly enlightening. I did not hear anything that I had not heard before. I must apologize to my colleagues in the international field who probably will not hear anything new from me.

Senator **Mathias**. However, consider that it may be new to the committee, so do not overlook anything. This committee has broad jurisdiction and attempts to cover a great many bases. We need all the help, advice, and counsel you can share with us. It is my belief that if we want to avoid unnecessary and unwise Government interference in the marketplace, we need to get basic information from the people most involved, that is, businessmen who are in the marketplace. Therefore, your testimony is of very great value here.

Mr. **Hostetler**. With that encouragement in mind, Mr. Chairman, I will try to support three observations. I will make my comments intentionally brief, and I would welcome questions in either these areas or any others.

The three points I want to make are:

First, the notion that the entry of Western Union into this particular marketplace, the international record communications marketplace, might lessen competition is, if I may put it politely, a creative idea. I will return to that observation.

Second, the underlying assumption for S. 1159, namely, that Western Union dominates the domestic record communication market—and I am talking about the same market that Mr. Knapp referred to earlier, though I do not agree with his definition—is without a factual basis. I will return to that observation soon.

Finally, I want to observe that in my opinion respectfully, S. 1159 is a bad bill.

IRC DOMINANCE IN INTERNATIONAL MARKET

Let me come back to these three points. I said that the idea that our entry into the international marketplace might lessen competition I find creative because in fact those who have looked at this marketplace have found that it is not a marketplace that is characterized by competition, at least historically. The recent Chairman of the FCC consistently referred to this industry as a cartel. The FCC specifically found that the earnings of the international record carriers were excessive by any regulatory standard, up to 58 percent by the admission of Mr. Knapp's firm.

This was made possible by the fact that indeed there has been no price competition and very little service competition over the years, so the idea that someone else, by entering that market, could lessen competition is somewhat paradoxical, to say the least.

Second, to the extent that there has been competition within the past year to 18 months, largely in response to the competitive efforts of others entering that marketplace, that competition has been characterized by anticompetive practices of the sort which might well provide a focal point for investigation by this committee.

In this connection, let me tie what I am about to say into another point which has been made by the international carriers; namely, there should be a moratorium because Western Union dominates the domestic marketplace and will be able to use that power to subsidize its entry into the international market, by noting that there has indeed been a moratorium since July of 1980, presently close to a year. Therefore, it is not only a bureaucratic delay, Mr. Chairman, but one imposed by virtue of the FCC's decision juxtaposed with the court of appeals decision taking us out of the international area pending the repeal of section 222.

Let me comment on what has happened during that period with respect to Western Union's position in the marketplace.

Senator **Mathias**. Will you put dates to those periods of time?

Mr. **Hostetler**. Yes. I am talking about the period July 1980 through the first quarter of this year. During the third quarter of 1980 we estimate that looking at outbound telex alone we sustained a diversion of 5 percent of the business which we had been handling. I am talking here specifically about the outbound handling of international telex messages.

It is very difficult to come by reliable statistics in this area. The international carriers are reluctant to provide specific data. We don't have access to as much data as we would like because to us international traffic looks like domestic traffic on our network, and the customers were billed historically by the international carriers for international service, so we focus on outbound traffic for that reason, because our information is better there than it is in other areas. Second, that is frankly where the first diversion was felt.

It was 5 percent during the third quarter; and an additional 5 percent during the fourth quarter. That diversion continued through the first quarter of this year. We estimate that at the present time the rate of diversion on outbound telex is about at the level of 13 percent.

This is what the international carriers have been able to accomplish in that relatively short period of time, attacking the so-called power base of Western Union.

I think this indicates that no carrier can rest assured that it is going to maintain any share of the market if it is unable to provide the service that the customers require, and in this case end-to-end service.

In addition, since July of 1980 Western Union's share of the international cablegram—the domestic handling of the international cablegram—business has suffered. We attribute the diversion level there at 45 percent of inbound cablegrams.

Earlier Mr. Pearce said Western Union handles all, or at least most, of the delivery of international messages. That simply is not the case anymore. His data is no longer current.

The international record carriers' success in diverting this business is not necessarily the result of a fair competitive process. This is the point I alluded to earlier. We believe it is due in large part to anticompetitive pricing practices. The IRC's control rates for international telex service. They have structured those rates to make it more expensive to use Western Union, or other domestic carriers for that matter, for the landline haul than it is to deal with the IRC's directly. How did they do this? Let me give you an example.

A customer living in Milwaukee who calls Western Union to send an overseas message to an international record carrier in New York would pay Western Union at least 45 cents a minute on top of the IRC's full international rate. The IRC's, however, since the expanded gateway decision and the implementation of that decision, again commencing in July of 1980, provide that leg from Milwaukee to New York in effect free without any additional charge.

Since Western Union is permitted to participate in only the domestic portion of a service, we cannot give away the domestic call and make it up through the international profits as the IRC's do.

In addition, the IRC's are giving away teleprinters in their new points of operation free of charge, an illegal practice which violates the IRC's own tariffs, FCC's orders, and section 203 of the Communications Act.

The IRC's are able to afford these unlawful practices for at least two reasons:

First, as an FCC audit showed, they are earning the excessive returns that I indicated earlier.

Second, these are enormous companies, such ITT, RCA, and Xerox, each of which has pretax profits which are 20 to 30 times those of Western Union. For the last 9 months of 1980 Western Union had pretax earnings of $32 million; ITT's pretax earnings, to take an example, were $871 million, 28 times our level, and Xerox was even higher.

Thus, the IRC's have very adequate resources to finance this unfair competition with which they are trying to eliminate Western Union as a potential competitor.

Now there was some question earlier about the degree to which the international carriers would be competing with us in the event we were permitted to go overseas. The IRC's were very anxious to make the point that all of their business is at risk and to leave the impression that they are, indeed, very small chips in this game. That simply is not the case.

Each of the three major IRC's is heavily committed to the domestic telecommunications marketplace. RCA is actively there today with other subsidiaries which are providing services similar to telex service. With ITT it is the same situation. Xerox has spent tens of millions of dollars in designing technology and has heavily promoted its intention to enter the domestic communications market. RCA is in the domestic satellite business.

Therefore, it is really not fair to look only at the international telex business which these international carriers are providing when one looks at the relative resources of the firms who are in this marketplace and which they are prepared to bring to the table in order to be competitive with each other.

WESTERN UNION NOT A MONOPOLY

Let me expand on that point, if I may, by looking with you at the domestic record communications marketplace. Mr. Knapp made the point that we are not talking about the total telecommunications market. I would agree with him that that is not the relevant market. I would agree with his statement that the relevant market is domestic record communications or switched record communications. However, that—and this is where I part company with him—is much more than TWX and telex.

Again data is somewhat hard to come by, but A.T. & T. is the dominant factor in the domestic record telecommunications industry through Dataphone. Dataphone transmission is not a separately tariffed service so it is difficult to know precisely what the size of that market is, but we believe reliably that there are well over 300,000 terminals connected to the Bell System, many of which, incidentally, are sending international traffic either directly over Bell Telephone lines or by interconnection with the IRC's.

We estimate that the revenue earned by the Bell Co. on the Dataphone service domestically is well in excess of $1 billion. That compares to $275 million in revenue for Western Union's TWX and telex service.

In addition, the facsimile market is out there. Facsimile is functionally the equivalent of TWX and telex in the sense that the subscriber to a facsimile service can attach that terminal to the Bell network, can dial a recipient to whom he or she wishes to send a message at the other end, and send that message and it looks just like a TWX and telex message when it comes out.

Again, the size of that market is difficult to appraise specifically. Perhaps this committee could do us all a service by gathering some of that data from those who are in a better position to provide it. However, our best estimate of that market is that there are well over 300,000 of those terminals installed in the United States as compared to something like 135,000 to 140,000 Western Union TWX/telex terminals. The revenue for 1980 in that marketplace may well be in excess of $400 million, moving according to forecasts to $600 million by 1984.

Another market that is developing is the so-called electronic mail market in which Graphnet, whose representative you heard from a few moments ago, participates. Graphnet is probably a rather small factor in that marketplace today. General Telephone has spent $60 million acquiring technology in that area and has spent tens of millions of dollars since that time developing the telenet network, which is a formidable entry in domestic record communications. SBS satellite system is entering this marketplace, having spent over half a billion dollars in resources to make that entry possible.

I suggest to you that, far from dominating the domestic switched record telecommunications industry, Western Union is a minor factor. We recently completed a market study. I say completed, but actually we recently commissioned and received a market study which we have submitted to the FCC in connection with proceedings there. This study tests customer awareness of options in the marketplace. Much to our chagrin, there are a good many business users in this marketplace who do not even think of Western Union when they think about this market.

Senator **Mathias**. Don't worry about that. We are familiar with that in the political world. Let me tell you my side of this. Recently they did a market study, so to speak, in the State of Maryland, and they found out that a third of the Marylanders had never even heard of me. I have been in public office for 25 years and was just elected last fall with 66 percent of the vote. I don't want you to feel in any way abused or slighted by the fact that the business community is not adequately aware of the service you offer.

Mr. **Hostetler**. I appreciate that statement.

Senator **Mathias**. There is sort of a sense of humility that is imposed upon us by results such as this.

Mr. **Hostetler**. We certainly feel that way ourselves.

Senator MATHIAS. We are all humble.

Mr. HOSTETLER. As to our role in the market, it is doubly disappointing to find that there are people who believe that we are dominant. That is not a perception which appears to be shared by most people.

Let me just comment a little on the dominance point from another perspective. The argument you always hear—and we heard it here this morning—is that Western Union has 140,000 terminals, they control 50 percent of the business, a little less than that, as you can see by the numbers I just quoted to you on what has happened to us in the last 9 months.

Be that as it may, however, what is the significance of the fact that we have 140,000 terminals out there? The best data we have indicates that only 84,000 of those terminals are sending any international traffic. That is roughly 60 percent of that population.

Of those, only 8,500 terminals are sending approximately 60 to 80 percent of all the international traffic which originates over our system. There is absolutely no significance to the raw number of terminals connected to our system when one is appraising dominance and whether or not we can extend such dominance as exists into the international marketplace.

Bear in mind 8,500 terminals is far fewer than the aggregate number of terminals which are installed and connected to the IRC networks.

In addition, almost all of those terminals are located in the expanded gateways where the international record carriers have been operating since July of 1980. The reason the IRC's are operating in 26 gateways is not because they were limited to that number of cities, but because on the basis of their market information, their experience in dealing with the customers over the years, they knew where the business was being generated, so they are at absolutely no disadvantage at the present time. In fact, for the past 9 to 11 months we are the ones who have been disadvantaged by what is going on in the marketplace.

WESTERN UNION OBJECTIONS TO S. 1159

Let me come specifically to S. 1159. Here I do want to be a little careful what I say because I am going to discuss this bill from a legal aspect. I want to rely on the advice of my counsel.

As we see it, S. 1159 would have two principal effects. First, it would give the IRC's new forums for litigation over the competitive impact of our entry into the international market.

Second, and perhaps more importantly, it would create new substantive antitrust standards applicable solely to Western Union.

Again, we heard reference here this morning about S. 271 being special interest legislation. I find that a difficult characterization to accept when what S. 271 would do is put Western Union in the same status that every other firm in this country has today. That is not special interest legislation to me.

On the other hand, legislation such as S. 1159 which could create a standard of conduct applicable only to one firm, Western Union—and that is the definition in the bill—is to my way of thinking special interest legislation.

If section 222 were repealed, Western Union would, of course, have to obtain authority from the FCC under section 214 before entering the international market. The Commission would be obliged to consider effects on competition as one important element of its public convenience and necessity determination.

By the way, a recent illustration of how the Commission operates in that area, and the extent of its statutory obligation in determining public interest, is evidenced in the recent SBS satellite decision. The FCC is required to take antitrust standards into account.

Under S. 1159 this tested and accepted procedure for resolving the complex and technical competitive issues pertaining to the communications industry would be radically changed. Section 16 of the Clayton Act would give the IRC's the opportunity to adjucate their claims of adverse competitive impact in the district courts by suing to enjoin what they would characterize as a threatened violation by Western Union of the new language to be inserted in section 10.

Since Western Union does business in virtually every judicial district in the continental United States, each IRC could choose the forum from the widest possible ranges of choices.

Thus, the possibility would be open for a series of actions by different IRC's in different districts, only one of which would need to succeed in order to forestall entry by Western Union into the international market.

There could be no assurance that the court would give any weight to the views of the FCC, much less defer to its expert judgment.

Moreover, even if Western Union were successful in the litigation seeking to prevent its entry into the international market, it would face unique threats of antitrust litigation after such entry.

It is, of course, true that without S. 1159 Western Union is subject to sections 1 and 2 of the Sherman Act and can be sued for conduct alleged to violate those laws, but Western Union apparently would be the only business entity in the United States subject to the additional provisions proposed to be added to section 10 of the Clayton Act.

Apart from creating new litigating opportunities for the international carriers, S. 1159 would create a unique, substantive antitrust standard. Under the present antitrust laws courts may not, except in very limited circumstances, intervene to prohibit commercial conduct until after the conduct has been proven to have had anticompetitive effect.

The only exceptions are those reflected in sections 3 and 7 of the Clayton Act under which exclusive dealing arrangements, mergers, and consolidations—types of transactions which experience has taught are likely to entail anticompetitive consequences—may be enjoined at their incipiency upon a finding that their effect might be substantially to lessen competition. There is no apparent reason to extend the incipiency approach to proposed market entry by domestic telegraph carriers through internal expansion.

Again I come back to the observations of Mr. Pearce, the expert who has been presented to this committee this morning to describe what is going on in the industry. I continue to be impressed by the fact that, while we are here to deal with a Western Union-only bill, and indeed Mr. Pearce did mention Western Union, 95 percent of his comments were directed to A.T. & T., which again is the dominant carrier in the domestic record communications business.

I find that a bill which totally ignores the realities of the marketplace and which addresses itself solely to protecting entrenched participants in a cartelized marketplace—not my observation—is a bill which at the very least is unfair and one which should hardly commend itself to the Judiciary Committee.

I welcome your questions.

Senator MATHIAS. First of all, I must say, Mr. Hostetler, it is apparent why you had no hesitation about proceeding without a script. I admire your ability to deliver yourself so forcefully and with such knowledge and with such command of the facts. That was a very impressive presentation.

Mr. HOSTETLER. I would hope, sir, that you at least found I had something to say as well.

Senator MATHIAS. Well—[Laughter.]

Mr. HOSTETLER. You don't have to vote now. [Laughter.]

Senator MATHIAS. I am old enough to remember a song which has a refrain which saying it is not what you do; it is the way that you do it.

You mentioned that the IRC's have captured 13 percent of your domestic market. What is your present market share of the domestic telex/TWX market?

Mr. HOSTETLER. In telex and TWX, it depends a little on how you define that market. If you define domestic telex and TWX as domestic traffic only, transitting a network pursuant to a so-called TWX or telex tariff, we have 100 percent. However, let me remind you that is a little like saying that Chrysler monopolizes the automobile industry because it is the only one producing Chrysler automobiles.

The question is, What is the relevant market? Facsimile, Dataphone services, and electronic mail are the functional equivalent of TWX and telex. Indeed, a good many messages which transit the IRC telex network today are originating on those networks. I am talking about Dataphone. I am talking about Graphnet-type services. They are not seeing our network at any point.

When you define what I call the relevant market—and I am using the same terminology that Mr. Knapp used before he lapsed back into TWX/telex—I estimate that market to be at well over $2 billion today, and our share of that market in terms of revenues is $275 million. My arithmetic is not very good, but that is not a dominant share.

Again, if you consider the TWX/telex market only but consider the domestic handling of international messages as part of that market, because pre-222 repeal that is the way it is, then the IRC's are entering that market directly today with considerable success at this point. The 13-percent number I used in the absence of any other data is as good as any.

Senator MATHIAS. I understand the point you are making exactly. I think it is one you have to keep in mind, and certainly which we have to keep in mind.

I was educated on that general theme some years ago by my dear friend, Rogers Clark Ballard Morton, the great late Secretary of

Interior, who took a very personal and very anguished interest in the Ballard-Mills case. Some of you who are deeply immersed in antitrust law may recall that case, but roughly, *Ballard-Mills* was a relatively small Kentucky food operation, a milling operation. They had a prepared biscuit formula, and had a very small share of the market. I do not have your command of figures so I hesitate to try to recall exactly the size of the share, but it was relatively small.

Ballard-Mills was bought out by Pillsbury. There was an antitrust proceeding brought against them. During the course of the antitrust proceeding the competition got two or three times the amount of the national market for prepared biscuit mixes that Ballard-Mills and Pillsbury together every achieved.

They finally got a decree against them, by which time Ballard-Mills had been condemned and torn down in Kentucky. Consequently, there was nothing left for the decree to operate against except the biscuit mix formula.

This measurement of what is a dominant share, then, is a very——

Mr. HOSTETLER. That is the way we feel about a moratorium—just 1 or 2 years until they get all our business.

Senator MATHIAS. I just cite that case to show you we are not unaware of the realities of life and that this is not some legal theory we are trying to spin out. Rather, we are trying to come to grips with the facts in the marketplace and what it is all about.

INTERCONNECTION

One of the complaints, and I suppose one of the reasons that we are all here today, is the fact that the IRC's apparently feel that Western Union has been less than cooperative in establishing interconnections in the 26 gateway cities. Western Union International claims it has been able to establish such connections in only 4 of the 26 cities.

Do you think there have been problems? If you do, to what would you attribute these problems in establishing interconnections?

Mr. HOSTETLER. There have been problems, and there will continue to be issues. It took people on my staff some 30 to 40 pages to provide the historical detail of the nature of those problems. I will not burden you with that here. However, let me try to summarize it this way:

In 1976, the FCC granted provisionally five additional gateways, allowed each of the IRC's to participate fully in each of the then-five existing gateways, so it was an expansion for some but not for others.

We had traditionally always interconnected with the IRC's at New York and San Francisco. That order said nothing about interconnection. Indeed, interconnection was not an issue at that time, nor had we ever been led to believe by any of the IRC's that additional interconnection points were desired.

However, commencing about 1 year later the IRC's did begin to request additional interconnection at these five gateway cities. Our position was that the interconnection which we were providing was sufficient. We had designed our network, spending literally every dollar we could bring to bear from our resources on the problem, to meet the needs of our customers. That was essentially a domestic network, referring back again to the numbers I gave you earlier which showed that only a small number of those terminals are used for international business.

It just did not seem to us we ought to be required to redesign our system to provide additional points of interconnection. That issue was raised at the FCC. Indeed, the FCC recognized the issue was there, and on at least one occasion said they had not yet addressed the issue.

This issue became more intense in 1980 after the 21 additional gateways were granted to the IRC's. At that point we voluntarily, before any order of the FCC issued, filed an interconnection proposal which would have granted each of the IRC's interconnection not at the five gateways but at the four cities in the hinterlands, so-called, where our computer switches are located.

To grant interconnection at the gateways would have required us to put additional facilities in, backhaul that traffic from our switch to the gateway and back to the switch, and I am not sure whose interest would be served by that.

Anyway, the switch city proposal which we voluntarily filed was one which we felt would go a long way toward meeting the IRC desires and it was one which we at least had some basis for supporting economically. It was in line with the way our system was designed.

At about that time, without even bothering to look at the filing which we made, the FCC issued an order and said that, lo and behold, since 1976 we had been in violation of a directive to interconnect. I might say that we have filed for reconsideration of that petition, and I am confident, though I have no inside information, that when the FCC is finished looking at the facts that order will be reversed.

Second, the Commission determined that it would investigate our practices to determine whether or not they were inspired by a desire to engage in anticompetitive practices. As far as we know, that investigation is largely completed. We have cooperated fully with the Commission. No evidence has been uncovered, because there is none, that we have engaged in anticompetitive practices, and we are confident that we will be exonerated.

Now coming to the future for interconnection, there are really two issues in interconnection. We have no problem in interconnecting with the IRC's. However, the issue is whether we should be required to redesign our system, which again at this point is essentially a domestic system, to meet changing and probably interim IRC requirements. After all, the IRC's are busy building their own network and replicating our facilities, so their continuing need for interconnection is likely to be diminished. In fact, what they are really after is to offload our customer base onto their system, and that is fine.

However, the issue is should we be required to design our system on an ongoing basis to meet those changing requirements? Second, if we are, should we be required to pay for it—that means really should our domestic customers be required to pay for it—without additional charge to the IRC's?

There are technical engineering questions, and I can assure you these are complicated. That is what the 40 pages are about. There are also economic issues. Therefore, I am confident there will continue to be debates over at the FCC about the terms of interconnection.

However, we are prepared to interconnect. We are willing to interconnect. We have tariffs on file which will permit that to happen.

By the way, I might say that we are going to be wanting some interconnection, I suppose, from some of the IRC's. When one talks about bottleneck facilities, over at the other end they are the ones with the operating agreements. In cases where we are unable to negotiate operating agreements, I am certain the IRC's will be happy to interconnect with us so that we can provide international service. I would hope so.

Senator MATHIAS. It has been charged by at least one of the IRC's that when Western Union was engaged in overseas telex service via Mexico and Canada, it engaged in anticompetitive practices, such as preferential repair policy, which are purported to encourage customers to utilize Western Union international telex over those of the competition.

Mr. HOSTETLER. That is based on one experience, I believe in North or South Carolina, where a Western Union serviceman, in violation of our internal operating procedures, in fact used that as an issue with a customer. That is not our policy. That salesman was disciplined. I regret that the IRC's, who share with us many of the day-to-day operating problems in this industry, would seize on that to characterize it as a Western Union policy.

Senator MATHIAS. You would contend that was one isolated incident?

Mr. HOSTETLER. Yes.

Senator MATHIAS. In the last 5 years, has Western Union had any conversations or negotiations that looked to the acquisition of, or perhaps a merger with, any international record carrier?

Mr. HOSTETLER. No, sir.

Senator MATHIAS. Does Western Union currently view its entry into the international record carrier market, either by merger or acquisition, to be a possibility? Is it feasible? Is it a corporate goal?

Mr. HOSTETLER. No, sir.

Senator MATHIAS. That perhaps takes us as far as we need to go today, Mr. Hostetler, pending the receipt of such written statement as you might wish to add to supplement your oral presentation. We might want to propound some written questions to you based on your additions, but we will provide adequate time for that.

Mr. HOSTETLER. We will be happy to do that, Mr. Chairman.

Again I would urge on this committee that one of the services it can provide, in my estimation, is to collect factual data about this marketplace, because antitrust law and policy should be based on facts and not unsupported statement.

We will be glad to provide all we can in any form requested.

Senator MATHIAS. I cannot speak for the committee, but I can speak for myself. That is precisely my feeling. There has been too much theory that has gotten into the whole practice and enforcement of antitrust law. That has been the basis on which I had hoped we might have a general review of the antitrust law, enabling us to compare it to the realities of the economic world in this generation.

Senator John Sherman was a very great Member of the Senate, and a very distinguished Secretary of State later in his life. However, Senator John Sherman lived a century ago, and the world has changed a great deal in that century. The marketplace has changed a great deal. I think it is essential that we keep the law consistent with the world in which we live. The law should advance as the world advances. Therefore, I am in complete agreement with you that the law should reflect the actual facts.

We are very grateful for your presentation. I think I have learned a great deal from the testimony here this morning, yours as well as that of others.

Will it inconvenience you to get your statement in within 4 days?

Mr. **Hostetler**. Absolutely not.

Senator **Mathias**. We would like to keep the record open for 4 days. If there should be any further necessity for any interrogatories to you, we can arrange for that. However, as of now, we will direct that the record remain open for 4 days.

Mr. **Hostetler**. We would very much appreciate it, sir.

Senator **Mathias**. Thank you very much.

The final witness today will be Mr. Richard Brandt, the chairman of the board of Trans-Lux Corp., Norwalk, Conn.

STATEMENT OF RICHARD BRANDT, CHAIRMAN OF THE BOARD, TRANS-LUX CORP., NORWALK, CONN.

Mr. **Brandt**. My statement is not terribly long, so we will all be able to eat lunch, I think.

My name is Richard Brandt. I am the chairman of the board of Trans-Lux Corp., a publicly held corporation doing business throughout the Nation. We appreciate the opportunity given to us today to testify before your committee on the subject of monopolization and competition in the telecommunications industry.

We have always favored competition. We are a small, stable company born out of the free enterprise system, unprotected by regulatory authorities and certainly not in a position to exercise monopolistic or oligopolistic power.

Trans-Lux has had experience with both vigorous competition and anticompetitive, monopolistic practices in telecommunications, and I am here today to share with you some of the lessons of our experience. My company has been in existence for over 60 years, getting its start by manufacturing terminals that provide visual display of stock exchange tapes. We continue today to furnish stock exchange visual display devices to the major U.S. stock and commodity exchanges and to numerous stock brokerage firms throughout the country. We also operate motion picture theaters in five States.

Our involvement in telecommunications began in the early 1970's when Western Union allowed its telex customers to provide their own terminal equipment. Trans-Lux saw a business opportunity and developed a modern telex terminal, which it then manufactured and sold or leased to Western Union's domestic customers. Today we are the largest independent supplier of modern electronic terminals used on the domestic telex network, accounting for approximately 10 percent of that market. We have leased and sold over 8,000 telex and TWX units to Western Union's customers.

While the market for customer provided terminal equipment on the domestic telex network is highly competitive, the same cannot, unfortunately, be said about the international telex market. We have run into formidable obstacles in attempting to gain a significant foothold with the customers of the international record carriers, or IRC's, and have sold only a handful of telex terminals to the IRC's customers. Our experience with the IRC's, which cross-subsidize their provision of terminal equipment to customers through higher message rate charges, suggests the need for continuing congressional and regulatory vigilance to prevent anticompetitive practices.

My testimony today will cover three broad areas: First, the basically positive experience my company has had with sales and rentals of customer provided equipment in the domestic telex market; second, the problems we have experienced in the international telex market; and, third, in light of these problems, the legislative safeguards we believe this committee and the Congress should consider.

There is no question that the public in general, and the telecommunications consumer in particular, has been well-served to date by competition in telecommunications equipment and will continue to benefit from increased competition in equipment and services. Many individuals and businesses are familiar with the wide diversity of telephonic equipment that has recently become available on an interconnection basis.

In the telex equipment market in which Trans-Lux operates, vigorous competition among equipment suppliers has given Western Union's telex customers substantial choice in their equipment decisions and has encouraged research and development by independent vendors, new devices, more customer convenience and—perhaps most importantly—low equipment charges. In addition, this equipment competition has led to a larger, more effective Western Union domestic telex network, because equipment suppliers, like ourselves, have brought in new telex customers through advertising, promotion, and selling.

These competitive benefits in the domestic telex equipment market arise because the equipment suppliers are independent of each other and, except for Western Union, do not provide any message services. Western Union, which does provide domestic telex lines, also sells and leases terminals but on a reasonably fair and arms length basis. This separation between equipment provision and message services seems to insure that there can be no cross-subsidization or tie-in sales, and as a result the public reaps substantial benefits through appropriately low message rates.

Unfortunately, the same cannot be said about the international record carrier market, and this brings me to my second area of discussion today. Customers of the IRC's are severely restricted in their selection of terminals, and their customers have little choice other than to use the terminals provided by the particular IRC's with which they are dealing. My company, which manufactures a high-quality terminal owned or leased today by a large number of domestic telex customers, has found it virtually impossible to sell or lease this same terminal to IRC customers.

The reason why we have not been able to sell our terminal, and why other manufacturers of telex terminals have not been able to sell theirs to IRC customers, is simple. The IRC's, which jointly have monopoly power, provide terminal equipment to their customers at rates far below cost, and in many cases for no charge at all. They make up for this subsidy of terminal equipment by substantially overcharging for message transmission.

As a result of this predatory pricing of terminal equipment, international telex customers are given a limited choice of equipment, and the independent manufacturers of telex equipment, like Trans-Lux, are effectively prevented from competing in a growing market.

The FCC is supposed to regulate these practices through its tariff procedures, but the IRC's have basically ignored FCC tariffs, as the chairman of ITT World Communications, Mr. Knapp, acknowledged in recent Senate testimony. The IRC's really do not dispute that their approach to customers is on an equipment tie-in basis, that they are in effect saying to their customers: "We will throw in the telex equipment for nothing or next to nothing if you send your messages with us."

This situation was bad enough when the IRC's operations were limited to five cities. Recently, it has become considerably worse. The FCC allowed the IRC's to expand to 26 cities, and then some. One condition of this expansion was that the IRC's would unbundle their transmission and equipment charges. We did not object to this expansion, believing that the unbundling condition would restrain the IRC's from bringing their onerous predatory practices into the new points of operation.

But in fact, the IRC's have flagrantly disobeyed the FCC's condition. As a result, Trans-Lux has lost a significant amount of business, since the IRC's customers have been unable to resist their below-cost and no-cost pricing of equipment.

In short, Mr. Chairman, the IRC's are before you today with unclean hands, continually in violation of the law, and the public is paying for it through the nose—in the form of higher message rates.

It already has been mentioned that rates of return of the IRC's have been shown to be extremely high. That is how they do it.

Those of us in the domestic telex terminal equipment market believe that international telex message charges should be based strictly on the cost of sending messages. IRC's should not be allowed to give away terminals at far less than their cost as an inducement to use their network. As long as they do so, independent terminal manufacturers like us are precluded from competing in the marketplace and the IRC's customers are denied innovative alternative equipment choices, as well as paying more than they should, much more, to send international messages.

Mr. Chairman, I know that among the members of this committee are some of the Nation's foremost experts in antitrust law and theory, fully knowledgeable as to why tie-in sales are usually considered illegal practices. The IRC's have, in effect, formed a cartel, dividing the market among themselves and refusing to compete directly with each other on the basis of the price charged to send messages. Instead, they compete on small, incidental items, much as the airlines in an earlier era of regulation competed with regard to meals, movies, and the like, rather than competing on the basis of the price of an airline ticket.

Because they can get away with charging a higher rate for messages than is justified by marginal cost pricing, the IRC's are able to provide their customers with free or nominally priced telex terminals and related equipment, even though substantial expenses are incurred in providing them. We thus have a classic tie-in situation in which monopoly revenues received in one market are used to subsidize below-cost or predatory pricing in another market—here, the telex equipment market.

Having provided an overview of the problem presented by the IRC's equipment practices, I would like to conclude my testimony by discussing the lessons we have learned that might be useful to this committee and the Congress. This committee has had a historic concern with protecting the public from anticompetitive practices that drive up costs and discourage entrepreneurial innovations. Such practices unquestionably exist in the international record carrier telex market.

I know that this committee has expressed an interest in proposals to repeal section 222 of the Communications Act and thus to allow open competition in the international record carrier market. My company supports open competition, including Western Union's entry into the international market, in the expectation that such competition will break up the comfortable cartel arrangement that the IRC's have at present. This will lead to more competition where it counts, with regard to message rate charges, thus probably forcing an end to cross-subsidization in provision of equipment.

There should be no moratorium. Western Union has already suffered from that moratorium.

There is a danger, however, that Western Union or other new entrants will find it more convenient to join the cozy club of IRC's, deciding that it is easier to join them than to fight them. To prevent this result, and to encourage competition in the telex terminal equipment market, we suggest that the Congress make it clear that it is opposed to the current IRC practice of tying or bundling telex equipment to transmission charges.

At the least, Congress could put some teeth in the law, directing the Federal Communications Commission to establish a rate system in both domestic and international markets that would mandate separate, cost-based charges for terminal equipment and for transmission services, and subjecting violators to significant penalties.

As greater insurance against cross-subsidization, we would actively support separation of the provision of terminals from the provision of transmission services. The IRC's are a powerful communications force, and they should not be allowed to directly provide their customers with the terminals used to send and receive their communications. As long as the IRC's are allowed to provide equipment, there is a danger of predatory pricing and cross-subsidization, a danger that no amount of regulatory vigilance can fully eliminate.

Separate subsidiaries, moreover, may not be a sufficient answer. As we have already seen in practice, no matter how high the wall a carrier is required to erect between itself and its subsidiary, the temptation of cross-subsidization will continue to exist. In the case of the IRC's, it may be necessary to limit IRC's and their affiliates from controlling or operating any company that sells or leases terminal equipment for use on the IRC network.

In summary, the present international record carrier situation has a number of detrimental consequences:

It leads to higher message rates for IRC customers;

It leads to less choice of equipment for telex customers;

It leads to predatory pricing of terminal equipment and restraint of trade by the IRC's; and

It leads to anticompetitive effects in the domestic telex equipment industry, particularly for the independent manufacturers of interconnecting telex equipment like Trans-Lux.

The best solution is one that protects the public and guarantees a free market for equipment suppliers, by ensuring that message rates and equipment charges cannot be bundled. A first step toward this free market is to allow Western Union to enter the international telex arena. The Congress ultimate goal should be to promote a vigorous market in telecommunications terminals alongside a vigorous market in telecommunications transmissions.

Mr. Chairman, Trans-Lux stands ready to work with you, the members of this committee, and the committee's staff to develop appropriate statutory language to implement these recommendations. Thank you for giving me the opportunity to testify on these important issues. I would be pleased to answer the committee's questions.

Senator MATHIAS. Thank you very much. I appreciate your statement. I can identify with your goal. My only problem is defining it.

The charges you make, of course, are very serious from a national point of view. It is estimated that by the end of this century, we will have to increase our experts twofold just to pay for the energy we will import. If there is going to be this remarkable increase in our international business, which such an increase in exports would involve, undoubtedly there will be an enormous increase in the international communications industry. Therefore, we are talking not only about a large industry today, but one which is on the verge of an enormous surge of growth and expansion. That lends an extra urgency——

Mr. BRANDT. As I predicted recently in an article in a trade magazine, international and domestic telex message gross dollar revenues would triple by 1986. I truly believe that, particularly with some of the deregulation that is going on.

Senator MATHIAS. I think it is entirely within the realm of possibility.

Mr. BRANDT. Our only problem is that we are losing equipment hand over fist to the IRC's who go out there and give it away when we have to charge for our equipment.

Senator MATHIAS. Let me ask you a little about the equipment business. Is it a competitive business?

Mr. BRANDT. Yes, highly competitive.

Senator MATHIAS. Highly competitive?

Mr. **Brandt**. Yes.

Senator **Mathias**. What share does Trans-Lux have?

Mr. **Brandt**. In the total teleprinter business, it has well less than 1 percent. I could not identify it. The largest company in it is Teletype, a subsidiary of A.T. & T., which has a very large share of the teletype business.

However, in the specific area of telex and TWX, we represent a larger share. As I pointed out, we represent roughly 10 percent of the telex market.

A small company like ours has to concentrate in an area. That has been our area of expertise and concentration. We do not like to see our market closed down because of anticompetitive acts.

Senator **Mathias**. Thank you very much for being with us. It has been very interesting testimony.

Mr. **Brandt**. Thank you.

Senator **Mathias**. The record will remain open for 4 days.

The committee stands adjourned subject to call of the Chair.

[Whereupon, at 1:25 p.m. the committee recessed, to reconvene at the call of the Chair.]

MONOPOLIZATION AND COMPETITION IN THE TELECOMMUNICATIONS INDUSTRY

WEDNESDAY, JUNE 17, 1981

U.S. SENATE,
COMMITTEE ON THE JUDICIARY,
Washington, D.C.

The committee met, pursuant to notice, at 2:10 p.m., in room 2228, Dirksen Senate Office Building, Senator Dennis DeConcini (acting chairman of the committee) presiding.

Present: Senators DeConcini and Specter.

Staff present: Peter Chumbris, counsel, and Marcy Tiffany, antitrust attorney, Jessica Josephson, counsel for Senator DeConcini.

OPENING STATEMENT OF SENATOR DENNIS DECONCINI

Senator DECONCINI [acting chairman]. The Committee on the Judiciary will come to order.

In the absence of Chairman Thurmond, I will chair the opening of these hearings which we are conducting today on the subject of monopolization and competition in the telecommunications industry. This is the second in a series of hearings that the Committee on the Judiciary is conducting on this topic.

At our first hearing, which took place last Wednesday, we examined the competitive situation existing in the international and domestic record-carrier industry.

In this hearing and the several to follow, we will be focusing more generally on the domestic telecommunication industry.

We would ask the witnesses to summarize their statements. We will include them in the record for review by members of the committee.

We will proceed to our first panel, which will be composed of Mr. C. Gus Grant, vice chairman of Southern Pacific Communications Co., and Herbert N. Jasper, executive vice president, Ad Hoc Committee for Competitive Telecommunications.

Gentlemen, if you would come forward, we will proceed with your testimony.

Any written statements that you have will appear in the record, without objection, in their entirety at the completion of each oral presentation; and we would appreciate your summarizing them for us.

Mr. Grant?

STATEMENT OF C. GUS GRANT, VICE CHAIRMAN, SOUTHERN PACIFIC COMMUNICATIONS CO., WASHINGTON, D.C.

Mr. GRANT. Thank you, Mr. Chairman.

I appreciate the opportunity to appear before this committee.

We certainly commend you for holding these hearings. They are very important at this critical time in our industry.

As was requested, my testimony will be limited to a description of the company that I represent and its relationship in the industry and to A.T. & T.

We do have a private antitrust suit against A.T. & T. which relates directly to the structure of that company. I have included some brief remarks in my prepared statement.

I am vice chairman of Southern Pacific Communications Co., a wholly owned subsidiary of the Southern Pacific Co., best known for its railroad.

We are classified as a specialized common carrier, and we provide long-distance service to 138 metropolitan areas in this country, which accounts for between 80 and 85 percent of the population.

We provide these services on our own terrestrial microwave system. Our services are voice, data, and facsimile. We have over 80,000 customers in the residential and business categories.

SP Communications' microwave towers are situated about 35 miles apart over our 8,000-mile network. Telephone signals are converted into microwave radio signals and transmitted between these line-of-sight towers.

We offer two basic services. One is a private line, where the line is used 100 percent of the time by the customer. The second is a switched long-distance service, where the customers share the system.

By the end of 1980, the system was carrying about 600,000 long-distance calls per day.

The trade name for our switch service is commonly called SPRINT. SPRINT requires no special equipment, other than a pushbutton telephone.

As part of our program, we are continually expanding this system. The map which is included with our written material indicates where our system is located.

In the telecommunication business, there is a clear distinction between long-distance transmission and local monopoly or utility service. The FCC and the courts have ruled that it is in the public interest to allow competition in the long-distance transmission business. The local areas, on the other hand, are served by one phone company, generally. Local telephone companies have a Government-granted right to serve the customers in that area.

You have probably heard lately that there is a lot of competition in the long-distance market. In order to clear the deck on that particular point, I should emphasize that all of the entrants in the long-distance market constitute about 1 percent of the total available business. The rest is handled by A.T. & T.

There is one unique segment of this business that is rather complex, but it is the basic structure of the whole industry.

We specialized common carriers compete with A.T. & T. on the one hand by competing with the Long Lines Department of A.T. & T. On the other hand, we purchase from A.T. & T. through their 23 Bell operating companies, who offer local service.

Therefore, we are in the rather unique position of having a customer relationship on the one side and a competitive relationship on the other.

This is complicated by the fact that A.T. & T. is organized along the lines of departments and operations, but it is designed in such a way that the total operation of A.T. & T., either subsidiaries or basic company, is subject to centralized control through a very intricate system of control—boards of directors of subsidiaries, stock ownership, and so forth.

With our unusual condition, the personnel of A.T. & T. in their subsidiaries or in their basic company, have an incentive to deal more favorably with their family members than they do with their competitors. Specifically, the operating companies from experience give better service to A.T. & T. long lines than to the specialized carriers.

We believe that a monopoly utility type of company, such as the local operating companies of the Bell Co., have an obligation to give equal service to all who ask for it.

As I mentioned earlier, these are critical times. There is the antitrust suit which is in process and should be allowed to conclude.

Congress has a unique opportunity to gain a lot of factual evidence from this particular litigation. Then there is the 1956 consent decree being reconsidered in the New Jersey court. Last, of course, there is the legislation before Congress.

For these reasons, I think this is a most timely activity on the part of the committee to look into the monopoly and structure of A.T. & T.

Thank you, sir.

Senator DeConcini. Thank you, Mr. Grant.

Let me just pose a couple of questions.

Would you describe in a little more detail some of the problems regarding competition and A.T. & T., and their dominance which, as you mentioned, is the basis of your suit? Exactly what is the background of that suit?

Mr. Grant. Our suit is based on the fact that, in our opinion, A.T. & T. has discriminated against SP Communications as a specialized common carrier in the provision of what we call local loop service.

Take any one of the Bell operating companies—C. & P., for example. Our contention is that we have been discriminated against in the service that we have been given by the local operating companies.

First, the service that is given basically is not equal to that made available to long lines. Our contention is that it has been given in a manner that has cost us time and money. It has not been technically equal, so it is a basic case of discrimination against a competing carrier.

Senator DeConcini. Meaning, in essence, that you are alleging that they give better service or more technical expertise to their own operations than they do to your use of their operations.

Mr. Grant. That is correct.

The manner in which we enter the Bell network is different than that from A.T. & T. long lines. As a result, our system is degraded.

Senator DeConcini. Without getting into the litigation, can you give me one example.

Mr. Grant. I will give you one example that relates directly to the customer. It is the first thing you encounter when you work with our system.

If you want to make a call on the SP Communications Network, you have to have, first, a touchtone telephone. You cannot do it with a rotary-dial telephone. That wipes out about 60 percent of the market right off the bat.

The reason for that is the manner in which we technically enter their system.

Second, if you want to make a call on our network, you dial 23 digits. You know from experience that if you want to make a long-distance call on the Bell network, you dial normally only 10 digits.

These two elements represent discrimination right off the bat, and we have not gotten into the technical area as yet.

Senator DeConcini. You are alleging that if they can do 10 on their system, they can do 10 on your system.

Mr. Grant. Ten, or perhaps at the most 12—but certainly not 23.

Senator DeConcini. Very good.

Would you describe your role as a smaller competitor of the Bell System? What are some of the problems that you see in the legislative approach of the pending bill before the Commerce Committee? I would like to know the scenario or the future of competition in the telecommunications industry under the present configuration.

Mr. Grant. That is a weighty question.

Let me just dwell on one point of that bill.

This is an issue that has been before Congress for the past years. This is the relationship of the competitive area of Bell and the noncompetitive area—the monopoly area—like your local telephone companies.

We contend that if competition is going to work and survive in this arena, the two segments of Bell must be divested. By that I mean that they must be under separate ownership.

On the one hand, we pay some 20 percent of our revenues to the local operating companies for service. On the other hand, we compete with Bell in the Long Lines Department.

You have a people problem here. You have a question of the loyalty and direction of people. This is what it comes down to.

If you are in a wholly owned subsidiary, which by the dictionary term is a controlled company, then you have a loyalty to the company that you work for.

It is our contention that it will not work on that basis. That is one of the basic elements of this bill.

The biggest problem of this industry today is the structure of A.T. & T.

A.T. & T. will contend that competition is growing. We have done a study on this thing, just to give you some of the scale on this. Competition by 1990, if we have a lot of luck and put in all the money that we can possibly raise as a competitive group and build as fast as we can, we will get up to about 8 percent of the business. We physically cannot become any larger.

As far as growing up to a size that you can take on the Bell System, there is no physical way it can be done.

Senator **DeConcini**. What percentage do you have now?

Mr. **Grant**. The entire industry has less than 1 percent. Our entire industry last year did $415 million. The Bell System in a similar category did about $26 or $28 billion.

You cannot find us on the map.

Senator **DeConcini**. We find you on the map in Arizona.

Mr. **Grant**. Absolutely.

Senator **DeConcini**. Can you discuss or give us an example of some of the specific leasing interconnect problems that you have had with A.T. & T.?

Mr. **Grant**. There have been numerous instances where circuits or facilities that we lease from the Bell System have been late in delivery. I think that is one of the major problems we have had.

We lease or rent a facility, and we have consistently been late in receiving the facilities. Consequently, we have been badly thrown off in our planning. This is the story of our lives actually.

Senator **DeConcini**. Thank you, Mr. Grant.

Mr. Jasper?

STATEMENT OF HERBERT N. JASPER, EXECUTIVE VICE PRESIDENT, AD HOC COMMITTEE FOR COMPETITIVE TELECOMMUNICATIONS, WASHINGTON, D.C.

Mr. **Jasper**. Thank you very much, Mr. Chairman.

We are pleased to have this opportunity to discuss the state of competition in the telecommunications industry.

Our committee was formed in 1976 to fight statutory monopoly legislation. Although the Bell bill was turned aside, pending legislation, also proposed by A.T. & T., presents a serious threat to the survival of competition.

We represent nine long-distance communications companies which compete with each other, as well as with A.T. & T. and Western Union.

THE LONG DISTANCE TRANSMISSION INDUSTRY

Our industry consists of four main types of businesses. The first is composed of specialized common carriers whose estimated 1980 revenues were about $400 million. These are sometimes called SCC's or OCC's. They chiefly use their own terrestrial microwave systems to provide voice and data services, which usually interconnect with the local telephone companies—or telcos—at either or both ends. They pay the telcos for provision of such facilities.

The second group consists of domestic satellite carriers [Dom Sats] whose estimated revenues were $110 million. They offer voice, facsimile, and wide-band data services using dedicated Earth stations, and provide television transmission to cable TV and broadcast companies. Some of them are also planning to offer switched-voice transmission services to the public, similar to those now offered by other SCC's.

Third are resale or value-added carriers whose estimated revenues were $75 million. They typically offer specialized services—that is, having added value—such as packet-switched data communications and facsimile transmission, utilizing computer-based switching equipment and lines leased from other carriers.

There is a new resale industry which offers communications over lines leased from either A.T. & T. or from SCC's and simply resells them to customers who benefit from the reseller's volume discounts.

Finally, there are miscellaneous or video carriers whose estimated revenues were $40 million. They relay through terrestrial microwave facilities, TV, and radio signals, principally to cable TV firms and broadcast stations.

Altogether, the competitive transmission business—all four categories of companies, not just the ones that our association represents—had estimated 1980 revenues on the order of $625 million. This excludes Western Union's terrestrial services but includes its Westar Satellite services.

In contrast, A.T. & T. had domestic long-distance revenues of about $25 billion. The independent telcos had toll revenues of about $8 billion.

Major competitors not represented by our organization include Western Union; Southern Pacific Communications; American Satellite; Tymnet; and Eastern Microwave. There are also more than a score of smaller resale companies and video carriers.

These categories, which I have just listed, however, no longer uniquely describe either the facilities used or the services offered. Some of the terrestrial carriers also lease circuits from each other or from A.T. & T., or even from Dom Sats. Some of the terrestrial carriers will soon be operating their own satellites.

RELATIONSHIP WITH THE BELL SYSTEM

The SCC's are dependent upon the telcos for local distribution if they wish to provide certain switched services, such as Execunet or City-Call or Sprint. Thus, the telcos have control over bottleneck facilities. Yet the kinds of connections the telcos provide to Bell long lines are substantially different from and superior to those provided to the SCC's. For example, the SCC's are given a line side, or two-wire connection, while long lines is provided with trunk side, or four-wire connection.

Mr. Grant has discussed two other kinds of discrimination, namely, the limitation to rotary dial phones and the 22-digit dialing. These matters have been under discussion, literally, for years.

For example, 2 years ago, in response to an MCI letter asking Bell for equivalent interconnection, a Bell official wrote to Mr. Wright, the president of MCI Telecommunications, and stated that A.T. & T. did not believe it was in the public interest for them to provide those equivalent connections to MCI.

We have long operated under the illusion that it is the FCC which determines what is in the public interest, and not A.T. & T.

Just last year, A.T. & T. chairman Charles Brown, a new-found disciple of competition, stated that "MCI will not get 10-digit interconnection," although that position would appear to be unlawful. Of course, Bell exploits this discrimination as a marketing tool, advising customers of the great inconvenience that they will experience with 22-digit dialing.

All three issues are still under discussion, under the aegis of the FCC, as is the whole question of the rates charged for local interconnection. The telcos have sought a major increase in charges for interconnection, even though the SCC's have pointed out that they are paying far more than the cost of the facilities actually being provided.

The Dom Sat carriers, some of whose services do not require interconnections, are also enlarging their offerings to include those that will need the same sort of interconnections as do the other SCC's.

EQUIPMENT SUPPLY

Our companies buy their equipment for transmission and switching, chiefly from U.S. suppliers. Some of their equipment is manufactured expressly to their own design and contributes to their economical and efficient operation.

These and other innovations have given the specialized carriers a competitive edge against the Bell System—an edge which A.T. & T. now seeks to deny—through gaining effective control, under its proposed legislation, over a new access charge system with which it hopes to handicap its competitors.

Thank you very much.

Senator DECONCINI. Thank you, Mr. Jasper.

I have been looking through your statement here. Perhaps I did not get to all of it. Can you tell me how many independents you represent in your Committee for Competitive Telecommunications.

Mr. JASPER. The number of companies that are actually associated with our organization is nine. Four are terrestrial microwave or satellite carriers, three are value-added or resale and two are miscellaneous or video carriers.

Senator DECONCINI. Are you at liberty to give us the names, or maybe they are here.

Mr. JASPER. Yes, they are in the statement.

That is, of a total population of new competitors—excluding the small ones in the last two categories I mentioned—on the order of a dozen companies.

Senator DECONCINI. You mentioned the problem that Mr. Grant brought up about the 22 digits. Have your other representatives or members of your association faced that same thing?

Mr. JASPER. Yes. We all faced that situation. Specifically, MCI has long been an active campaigner at the FCC and with A.T. & T. to achieve equality of interconnection.

Senator DECONCINI. Are any of your members in litigation with A.T. & T. over the same subject?

Mr. JASPER. Yes. MCI has won a jury award in a Chicago district court of $600 million, trebled to $1.8 billion. That case has been appealed to the circuit court, and the hearing has already been held. We are awaiting action by the circuit court.

MCI has filed a second antitrust suit in the district court in Washington, which is in the pretrial stage. Specifically, it alleges discrimination of precisely the sort of thing about which you are inquiring.

These matters are also issues in the Federal antitrust court case which is in litigation in Washington.

Senator DECONCINI. Is the one in Chicago a discrimination case?

Mr. **Jasper**. Discrimination was alleged in the Chicago trial. The jury found for MCI.

Senator **DeConcini**. Just out of curiosity—for someone who does not have a great knowledge on this—what is the reason that A.T. & T. gave your representatives for a 22-digit number, rather than something less?

Mr. **Jasper**. They alleged several things, but I think the most dramatic is the one I alluded to when they stated that they simply did not think it was in the public interest to provide those interconnections.

They have made other statements to the effect that they operate a national network, and as we are not part of the network, we should not interconnect with it in the same way that they do.

They, of course, allege technical and economic obstacles.

Senator **DeConcini**. Have they showed you any technical obstacles?

Mr. **Jasper**. Nothing that has persuaded our companies.

Senator **DeConcini**. Do you concur with that, Mr. Grant?

Mr. **Grant**. Yes, sir.

Mr. **Jasper**. I should add, as Mr. Grant said, that it may well be, if direct dialing equalization is to be given to all companies nationally, that we would need an 11-digit or 12-digit system, rather than a 10-digit system.

That would seem to be the necessary condition under which free competition can emerge in this industry. Certainly we do not have, as Mr. Grant has so well pointed out, effective competition at this stage with our miniscule market penetration.

Senator **DeConcini**. Do your technical advisers satisfy you that A.T. & T. could supply this for far less than 22 digits, for instance?

Mr. **Jasper**. Yes. There is no question about that at all. As a matter of fact, much of the network is now engineered to handle 15-digit dialing already, as the network has been improved to handle direct worldwide dialing, for example.

I do not say that this can be done overnight or "for free." That is not the question. The question is whether it is technically and economically feasible. Our experts believes that it certainly is.

Senator **DeConcini**. Can you give us your opinion—either of you. It seems to me that one of the things you are saying is that A.T. & T. ought to be restructured in some manner. Do you care to give an opinion on exactly how that should be accomplished?

Mr. **Grant**. I am addressing this a little bit from a parochial standpoint, because there are many facets of A.T. & T., like Western Electric and items of that type.

Senator **DeConcini**. You mentioned divestiture in your statement.

Mr. **Grant**. Let me just take one point that affects all of the competitive carriers—not the equipment people. I believe they have ideas that would add to this.

We believe that the local operating companies—Bell operating companies; there are 23 of them in the United States—should be divested from A.T. & T. and be set up as separate stock companies. They are actually separate stock companies today.

Senator **DeConcini**. What is the reason for that?

Mr. GRANT. They provide the local monopoly service which all of us must have in order to survive. We have to buy from them.

We do not believe that they, as monopoly providers, should also belong to the same company that owns that entity that competes with us, which is Long Lines.

Our suggestion is that Long Lines remain with the parent A.T. & T., and that we compete with them. And that 23 Bell operating companies, which are already subsidiary companies with stock, be spun out as separately owned stock companies and be separate from the Bell System.

It is like we are in a cider press. On one side we have the Bell operating companies squeezing us with what we consider to be discriminatory rates and services. On the other side, we have Bell Long Lines, which is an aggressive company, selling their services against us. We are in the middle.

When you have them both under one control, you have an impossible situation.

Senator DECONCINI. Does the local Bell System you refer to that has to sell or make some arrangements with Long Lines charge a different fee to Long Lines than they charge to you?

Mr. GRANT. We do not know what they charge Long Lines. Somehow that information gets lost every time we ask.

Senator DECONCINI. Could the problem be resolved by making that public, or making it so that they cannot charge anyone any more than they charge anyone else?

Mr. GRANT. I do not believe so, sir. When you have a common ownership, you can shuffle money and costs around many, many different ways.

Senator DECONCINI. Do you mean if they had a rate schedule which was set by some authority which they had to charge Long Lines, or your company, or Mr. Jasper's that this would not suffice?

Mr. GRANT. We do not believe that, although it has been tried.

Senator DECONCINI. That was my next question.

Mr. GRANT. Let me put it this way.

Over the years that I have been in this business, which is 8—my company is 8 years old—we have yet to compete with A.T. & T. in the private-line sector, because that is the longest history we have, against a tariff that has been completely approved as to cost justification by the FCC.

We have yet to compete against them with a fully approved tariff. The costs have never been justified.

We still do not know whether those costs that we are competing against are legitimate or not.

If you cannot do it in that period of time on that comparatively narrow segment of the business—private line is only 4 percent of the market—I just cannot believe or see how the company would have the incentive to do it on the broad scale of the long-distance market. We just do not think it is workable.

Senator DECONCINI. Mr. Jasper, do you have anything to add?

Mr. JASPER. I would like to add comments on two facets of the matter.

In hearings before the Senate Commerce Committee in 1977, John deButts, then chairman of the board of A.T. & T., alleged that there were substantial cross subsidies among various services. He was asked by Senator Danforth if he could tell the committee which services earned a profit and which operated at a loss. Mr. deButts responded that he did not know which services were fully recovering their costs and which were not.

The state of accounts in the A.T. & T. company has not improved greatly. In testimony 2 years ago, they said that they were 4 years through an 8-year study on which they had already spent $400 million and still did not have the answer.

Another point that is worth noting, and it is what I closed my oral statement with, is the allegation that the access charge provisions in the pending Senate legislation are engineered in such a way that A.T. & T., through its influence over State officials, would control a majority of the joint board that would administer some of the functions necessary to setting access charges.

It could deliberately rig the system so that access charges were inordinately high. Even if Long Lines paid them, they would be paying the overcharge to themselves, in the form of the Bell operating companies.

Senator DECONCINI. Now are you suggesting that there would be some impropriety?

Mr. JASPER. No, just the fact that A.T. & T. controls all the information, just as Mr. Grant cannot tell you what the facts are, because A.T. & T. will not reveal them. They reveal information selectively to State regulators and Congressmen, so that nobody has the answers.

Because of the power of the company, in access and numbers, both in employees and consultants, it is able to convince the Congress that these oft-repeated assertions—which are devoid of factual support—must be true, because nobody can disprove them.

Bell is sitting on top of all the information and is carrying the day without the Members of Congress demanding the answers before they pass legislation.

Senator DECONCINI. No Members of Congress have demanded that information to your knowledge?

Mr. JASPER. A.T. & T. knows how to evade questions in 150 different ways. I can refer you, for example, to the most recent of evasive answers.

In questions propounded to A.T. & T.'s vice president and general counsel by the House Subcommittee on Monopolies and Commercial Law—the answers are in the appendix to the committee report—you will find places where he just did not answer the question. People get tired of asking the same question over and over again.

A.T. & T. sometimes does not answer. Sometimes it obfuscates. It switches its terminology. In some fora it says subsidy; in others, it says contributions. It has everybody so confused that nobody has the facts.

Senator DECONCINI. Therefore, what you are saying is that there has never been, to your knowledge, satisfactory answers to congressional inquiry of where the profit breakdown is or where the cost breakdown is in the various subsidiaries of A.T. & T.?

Mr. JASPER. That is absolutely correct.

Senator DECONCINI. Until that is available, your contention—and I somewhat agree with you—is that it is difficult to know whether or not you could do it through some type of tariff setting.

Mr. JASPER. That is correct.

Another facet of this is developed in my prepared statement where I make reference to the panoply of services which the Bell operating companies provide to Long Lines but which they do not provide to us, for example, directory assistance, billing and collecting, and advertising. We do not receive those services. Should we pay the same as Long Lines if we do not get the services? We have no idea what, if anything, Long Lines pays for those services.

I did want to touch on the structural question briefly if I might.

Senator DECONCINI. Please do.

Mr. JASPER. I just want to address myself to the comments Mr. Grant made in his prepared statement.

There is no such thing as a fully separated subsidiary. If it were fully separated, it would not be a subsidiary.

As Mr. Grant said, and Professor Schwartz testified in the House hearings last year, it is a contradiction in terms.

However, if you really wanted an affiliate or wholly owned subsidiary, which was reasonably independent from the parent, there are a number of provisions in pending legislation which would have to be changed. There is provision for management direction from the parent company. There is provision for joint ventures and partnerships. There is provision for joint advertising. The list goes on and on, so it is not fully separated.

Furthermore, the committees that have approved or have proposed legislation relying on the separation of an affiliate have completely overlooked all of the objective studies of this matter—studies by Federal agencies, the GAO, the FTC, and studies by consultants who are experts in the field. For example, Arthur D. Little did a major study for our association in 1977 of the efficacy of a regulated affiliate as a means of protecting competition.

That company does a great deal of consulting for A.T. & T. Thus, it is expert in the affairs of the company and is rather judicious about anything it would say that would be critical of A.T. & T. It concluded that a fully separated subsidiary really does not make enough difference to protect competition, even if it were regulated. Yet the pending legislation would depend on an unregulated affiliate.

Senator DECONCINI. I have no further questions. There may be some other questions that members of the committee will submit to you. We would appreciate it if you would respond to those.

Thank you, gentlemen.

[The prepared statements of Messrs. Grant and Jasper follow:]

PREPARED STATEMENT OF C. GUS GRANT

INTRODUCTION

Thank you Mr. Chairman and members of the Committee for giving me this opportunity to testify before you today. We commend you for holding these hearings.

As you have requested, my testimony today will be limited to a description of Southern Pacific Communications Company (SPCC), our services, how we got into this business and a brief description of AT&T and SPCC's relationships to that corporation. Because SPCC's private antitrust suit against AT&T relates so directly to the structure of AT&T, I have also included a brief description of our suit.

I understand and appreciate that I will be invited to return at a later date to discuss in detail specific problems that we experience because of the structure of the telecommunications industry today, and to discuss specific solutions or legislative proposals.

DESCRIPTION OF SPCC AND ITS SERVICES

SPCC is a wholly owned subsidiary of the Southern Pacific Company (SP) which also owns a major western railroad. Its headquarters are in San Francisco, California.

SPCC's headquarters are in Burlingame, California. SPCC is a specialized common carrier of communications. We provide long-distance telecommunications services including voice, data and facsimile through both dedicated private line and switched services offerings. SPCC's long distance coast to coast network presently serves 138 metropolitan areas. Attached is a map which will give you an idea of where SPCC's system now runs. SPCC's network is largely a system of terrestrial microwave facilities. Microwave towers are situated approximately every 35 miles along SPCC's 8,000 mile network. Telephone signals are converted into microwave radio signals and transmitted between line of sight repeaters which look like big dishes on each microwave tower.

By the end of 1980, the system was carrying an average of 600,000 long distance calls per day. SPCC has over 80,000 customers. SPRINT is the name of our service which is used mainly by business customers who want an alternative to the traditional telephone company's service. SPRINT Ltd. is our off peak service that appeals mainly to residential customers.

At the end of 1980, SPCC had 1,650 employees. SPCC uses the latest, state of the art technology and the most up to date equipment in its system. This means that SPCC's system is not labor intensive, but technology intensive.

SPRINT service is available 24 hours a day. A SPRINT call requires no special equipment other than a push button phone. The customer dials a local 7 digit number which reaches an SPCC computer switch. The call travels from the customer's premise via the local telephone company's facilities to the SPCC switch. Once the customer has dialed the 7 digit local SPCC number and gets a SPRINT dial tone, the customer must enter at least a 6 digit identification code. This code identifies the caller for billing purposes. Immediately following this authorization code, the customer dials the area code and 7 digit phone number of the party in the distant city. The call travels the long haul from city to city over SPCC's system but when it arrives at the distant city, it travels from SPCC's local switch to the called number via the local monopoly telephone company.

SPCC is continually expanding the system. You will notice that the map of SPCC's system does not show routes to Florida or the states of Washington and Oregon. By the end of 1981, we hope to have leased line connections from AT&T to those areas completed. SPCC was recently authorized by the Federal Communications Commission (FCC) to serve the state of Hawaii. Of particular importance to SPCC's future growth was the recent approval of our satellite application. SPCC is authorized to construct and launch two satellites and to build a third to serve as an on-ground spare. Launch dates are tentatively set for February and October of 1984. This satellite system will be used in conjunction with our terrestrial system and will allow us to expand into new geographic areas and to provide video services.

In addition to our long distance transmission services, other SPCC subsidiaries provide high-speed facsimile and other telecommunications equipment and electronic mail services. Although SPCC is expanding into creative new service areas, it is mainly a service business, not a manufacturing business, and our main service is long distance transmission service. Our service is like an alternative highway system for users of telecommunications products and equipment in this country to get from one city to another. The most advanced modems, facsimile equipment, computers and word processors etc. all rely on a transmission network, a path, or a highway to communicate. The FCC and courts have ruled that it is in the public interest to allow competition in the long distance transmission business.

Local areas on the other hand are served by one phone company. Local telephone companies have the government granted right to be the only telephone company to serve customers in that area. Local telephone companies have the right to receive a guaranteed rate of return on their investment. Also, AT&T's long distance entity receives a guaranteed rate of return.

SPCC does not receive a guaranteed rate of return. SPCC's rates are subject to the marketplace--consumer demands and satisfaction.

HOW SPCC GOT INTO THE BUSINESS

SPCC's heritage dates back to 1862 when Abraham Lincoln signed the Pacific Railway Act and chartered Central Pacific, Southern Pacific's predecessor, to construct a "railway and telegraph line." The railroad operates one of the largest private microwave networks in the country. After the second world war, there was a tremendous demand by certain large telecommunications users such as the railroads, airlines and trucking companies for new services and facilities. AT&T did not meet these demands adequately. The FCC authorized certain large users to construct their own private communications systems. Southern Pacific did. When the FCC opened specialized communications to competition, it was natural for SP to form a company to become a part of this dynamic and rapidly growing industry. SPCC was established in 1970. Its initial network followed the railroad's right-of-way from San Francisco to Dallas. SPCC's system grew rapidly and today it is a coast to coast system that is independent of the railroad. In December of 1973 SPCC began providing private line service on its system. Private line service means there are dedicated communications channels between particular locations. This service is used mostly by organizations with high use of telephone, teletype computer data or facsimile traffic. It was in 1977 that SPCC began providing switched services. These are most easily described as long distance calls that the average business or residential customer would make. There is no dedicated line reserved. Rather the call enters a network and could travel over any number of paths to its destination. As you can see, SPCC is a very new entrant in this competitive telecommunications business. We provide a good service and there is a strong demand for it. Customers want a choice. We want to provide that choice.

SIZE OF AT&T IN COMPARISON TO SPCC AND SPECIALIZED CARRIERS

No one would contest the fact that AT&T dominates all facets of the telecommunications industry. The arms of the Bell System reach out and touch all communications markets and services. The massive size of this vertically and horizontally integrated monopoly is overwhelming. Here are some statistics.

Revenues

AT&T's total operating revenues in 1980 were $50.791 billion. SPCC's total operating revenues in 1980 were $152 million. All specialized carriers together had revenues of about $415 million. This means that SPCC's revenues in 1980 were .3 percent of AT&T's. This also means that the specialized carriers' revenues combined were only .8 percent of AT&T's.

AT&T's 1980 revenues increased from 1979 by $5.383 billion or 11.9 percent. SPCC's revenues in 1980 were only 2.8 percent of this increase. The specialized carriers combined revenues in 1980 were 7.7 percent of this one-year increase. To explain the numbers in another way--the increase in AT&T's revenues from 1979 to 1980 was 13 times the combined revenues of the specialized carriers.

It would be misleading if we did not explain that you really must look at a different set of numbers as well as those above if you want to get the most accurate picture of the size relationship between AT&T's intercity, long distance business and the new competition from specialized carriers. Of the total AT&T revenues for 1980 cited above, over half, or $26.133 billion were from intercity services. This is the part of AT&T's business that specialized carriers compete with. SPCC's revenues of $152 million in 1980 were .6 percent of AT&T's, and the specialized carrier's combined revenues of $415 were 1.6 percent of AT&T's long distance revenues. About 25 percent of SPCC's revenues go back to AT&T for Local Distribution payments.

If we asume AT&T will continue its current rate of growth of about 12 percent per year in total operating revenues through 1985 (and that is a fair assumption), its total revenues will be over $89 billion. If the specialized carriers continue to grow at 40 percent per year, their total revenues will be approximately $2.3 billion in 1985, or equal to about 2.5 percent of AT&T's total revenues.

Competition has begun to develop in the long distance business. The long distance market, however, is far from being subject to effective competition, by any standard. It is and will remain dominated by AT&T for years to come.

Employees

In terms of employees, there were over one million in the Bell System in 1980. SPCC had 1,650 employees in 1980.

Assets

The Bell System had total assets in 1980 of $123.69 billion. SPCC had assets in 1980 of $268.7 million. This means that SPCC's assets in 1980 were .2 percent of AT&T's.

Based on assets from the Fortune 500 compilation, AT&T is larger than the top 3 combined (Exxon, Mobil and GM). It is almost three times larger than its four largest potential competitors combined (IBM, ITT, XEROX and RCA). For the most part, these potential competitors have most of their assets committed to non-communications industries or services which minimize their direct competition with AT&T. The amount of assets a corporation has dedicated to other industries does not necessarily reflect its ability or desire to undertake a large commitment in telecommunications.

Construction

AT&T's construction expenditures in 1980 for improving and expanding its system were $17.3 billion. SPCC's annual construction and equipment expenditures in 1980 were $69.9 million or .4 percent of AT&T's. To explain the numbers in another way, SPCC's total revenues in 1980 were equal to 10 percent of what AT&T spent on construction expenses.

Obviously, it is physically impossible to build a system rapidly enough to make a significant dent in AT&T's long distance share of the market for years to come. Although the growth rate of new competitors of AT&T's long distance entity is heartening, on a scale of one to one hundred with AT&T being one hundred, the competitors in the long distance transmission business are still hovering in the area around one.

It is simply incorrect to believe that the communications industry today is experiencing any kind of fully effective competition.

BRIEF DESCRIPTION OF AT&T: THE CONSOLIDATED HOLDING COMPANY

In order to understand how one segment of the telecommunications industry competes with AT&T, it is important to understand the ways in which the many parts of AT&T are formally and informally locked together to insure their responsiveness to centralized direction and control, which in turn makes it possible for AT&T to orchestrate the policies and conduct of the parts to advance its overall corporate interests.

AT&T stands at the apex as a holding company consisting of many separate corporate entities with assets of over $123 billion, making it the largest corporation in the history of the world. The major entities are the Western Electric Company, Bell Telephone Laboratories, and the 23 Bell Telephone operating companies. AT&T owns 100 percent of the stock of the Western Electric Company. AT&T and Western Electric each own 50 percent of the stock of Bell Telephone Laboraties. AT&T owns or controls 23 telephone operating companies which provide telephone and other telecommunications services to the overwhelming majority of telephones in the United States. It is the monopoly supplier of telephone service in almost every major city in the United States.

It is interesting to note that while the Bell operating companies serve less than 50 percent of the land area of the continental United States, they serve 80 percent of the phones. About 1,500 independent telephone companies serve the remaining 20 some percent of the telephones and over 50 percent of the land area, mostly rural and low population density areas of the country.

Attached for your information is an organizational chart of AT&T from a 1977 analysis of the telecommunications industry restructuring prepared for the Ad Hoc Committee for Competitive Telecommunications by Arthur D. Little, Inc. Although this chart is outdated in some respects, it accurately reflects the relationship of AT&T Long Lines Department to the Bell operating companies and with the parent. Long Lines Department is not a separate subsidiary of AT&T. As you can see from the chart, AT&T is divided into 1) a Long Lines Department which connects the various Bell operating companies to each other and provides interstate telephone and private line service and 2) the General Departments which provide advice and assistance to the Bell operating companies, control, set policies and run the holding company. Standard agreements with each of the Bell operating companies, called license contracts, exist between AT&T and each of the Bell operating companies.

The effect of the license contracts is not only to enable the companies to transfer cost back and forth on their books, but also to establish a system of dependency which removes the independence and autonomy of decision-making by the operating companies.

In addition to the license contract mentioned above, AT&T controls and coordinates the activities of the Bell System through 1) ownership of all or a significant part of the stock of each of the 23 operating companies, Bell Labs and Western Electric, 2) representation on their board of directors, 3) a standard supply contract which generally obligates Western Electric to supply the needs of the operating companies for equipment and supplies, 4) Multi-Company Committees, councils and other collegial groups to make policy in specific areas. They coordinate and direct the activities of the companies and agree on priorities to be followed in developing new systems or products, and 5) selection and rotation of management among AT&T, Western, Bell Labs and the operating companies. AT&T Long Lines Department has responsibility for overall management of the nationwide AT&T telecommunications network. It owns and operates long distance transmission facilities and certain switching systems to provide connection between and among the Bell operating companies, pursuant to the license contracts. It also provides connections with foreign countries. Because many states have laws that require property located in the state to be owned by a corporation chartered by that state, AT&T has separate corporate subsidiaries in many states which own properties operated by Long Lines Department.

With this background, we will move ahead to explain SPCC's relationship to AT&T.

1. SPCC Competes With AT&T's Long Distance Network

SPCC provides intercity (long distance) telecommunications transmission services over its coast-to-coast microwave transmission facilities across the United States. Under recent FCC decisions, SPCC has the right to serve all parts of the continental United States and the state of Hawaii. Our services are similar, but not identical to, a number of services of the Bell System's long distance network.

2. SPCC Is A Customer Of The Bell Operating Companies

The Bell System, through its 23 local telephone operating companies serves approximately 80 percent of the telephones in the United States. The local telephone operating company exchanges are what is referred to in antitrust terms as "essential" or "bottleneck" facilities.

SPCC is a very substantial customer of AT&T's bottleneck local distribution facilities. SPCC must use these bottleneck distribution facilities in order to complete calls to our customers. We cannot run telephone lines into the individual homes and businesses of our customers. Our network is a long haul facility. SPCC spends approximately one fourth of its gross revenues for local interconnection and distribution services. As such, SPCC is one of AT&T's largest single customers in many local service areas.

Because AT&T controls the Bell Operating Companies, it is able to control the terms and conditions under which those facilities are made available to intercity (long distance) competitors. SPCC's problem from the beginning has been getting interconnections from the Bell Operating Companies equal to that which they provide their own interexchange (long distance) network.

BRIEF DESCRIPTION OF SPCC'S ANTITRUST SUIT AGAINST AT&T

SPCC filed a private antitrust suit against AT&T in March of 1978. Southern Pacific Communications Company v. American Telephone and Telegraph Company, Civil Action No. 78-0540. SPCC filed "Plaintiff's First Statement of Contentions and Proof" in the United States District Court for the District of Columbia in this case on November 24, 1980. A trial date of May, 1982 has been assigned.

In this suit, SPCC is alleging that AT&T has, for some time, been engaging in an illegal program to maintain its monopoly in intercity telecommunications. Listed below for your information are some of the specific areas where AT&T has attempted to preclude entry of competition. The items listed below appear in the "Plaintiff's First Statement of Contentions and Proof":

--Sham Negotiations

AT&T continued negotiations even after deciding that it would not enter into interconnect contracts with SPCC at all.

--Territorial Restrictions

AT&T placed an arbitrary limit on the areas in which SPCC could obtain interconnection.

--Customer Premise Restrictions

AT&T refused to end or terminate any phone line at any location other than the customer's premise. This required SPCC to use more complex and longer circuits, precluded SPCC from serving some customers, degraded the quality of the service SPCC could provide, and increased costs.

--Refusal To Provide Interconnections

AT&T refused to provide SPCC with interconnections necessary to provide FX and CCSA services.

--Self-Appointed Policeman

Whenever in AT&T's sole judgment a circuit was intrastate and not authorized, AT&T simply refused to provide the local interconnection SPCC needed to serve its customer even though the definition of intrastate service they relied on for this purpose conflicted directly with the definition they had used for over 25 years.

--Discriminatory Treatment

AT&T order and repair operations discriminated in favor of Long Lines and against SPCC.

--Piece-Out Restriction

AT&T through "piece-out" restrictions was able to prevent SPCC from competing for parts of circuits.

--Use Of Local Monopolies To Collect Competitive Information

AT&T established a tracking and surveillance program in which full information on SPCC customers was collected for AT&T's marketing department.

--Anticompetitive Rates

AT&T continued in effect the Telpak rates for over 19 years of legal proceedings before the FCC and during which time AT&T never succeeded in gaining legal approval for that tariff. It devised Hi-Lo and MPL rates which drastically lowered the charges in those particular areas where there was competition from SPCC and other specialized carriers. Its DDS Rates (for Digital Transmissions) were also rejected as below cost and anticompetitive. Following prolonged proceedings before the FCC these rates were held unlawful.

--Sham State Tariffs

AT&T filed tariffs with the states for local distribution despite the fact that AT&T knew that state agencies had no jurisdiction.

--Abuse Of Ratemaking Procedures

AT&T continually filed rates which it could not justify. After years of legal proceedings in these different rates, AT&T's justifications for these rates were rejected.

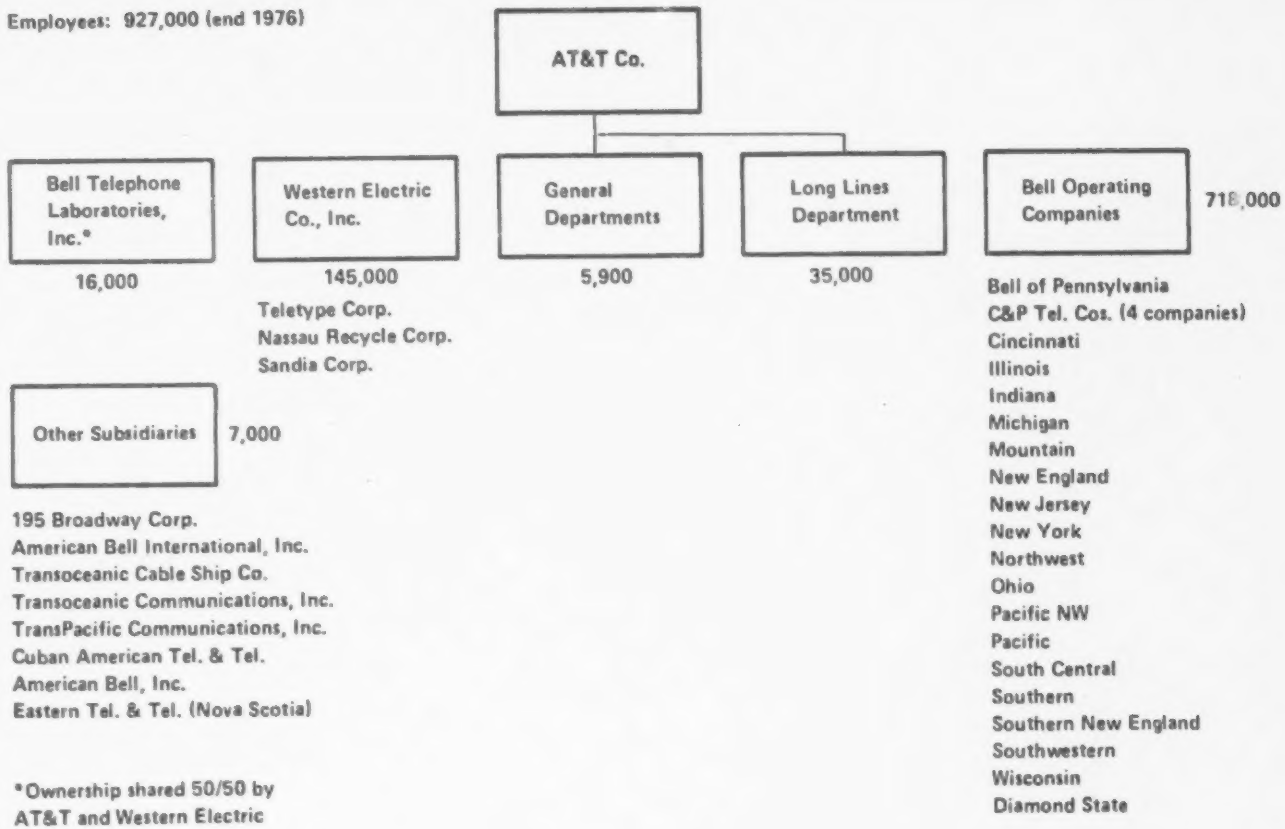
CONCLUSION

SPCC has been an active and vigorous participant in the legislative debate on how to reform the communications statutes since the issue came before the Congress in the mid-1970s. During that period we have continued to grow and expand in the market so thoroughly dominated by AT&T. Our experience is that effective and fair competition does not exist in the long distance transmission market today. AT&T's dominance, absent structural remedies by the court or Congress, is expected to continue through the balance of the century. AT&T continues to abuse its market power and act in an illegal and anticompetitive manner, despite attempts by the FCC and courts to prevent it.

The structure of the Bell System is at the heart of the industry's problems. The question for the Congress and the courts is whether AT&T should have under one corporation, a regulated utility business and an unregulated competitive business. SPCC submits that such an arrangement is not in the public interest. The relationships between the two businesses cannot be policed adequately.

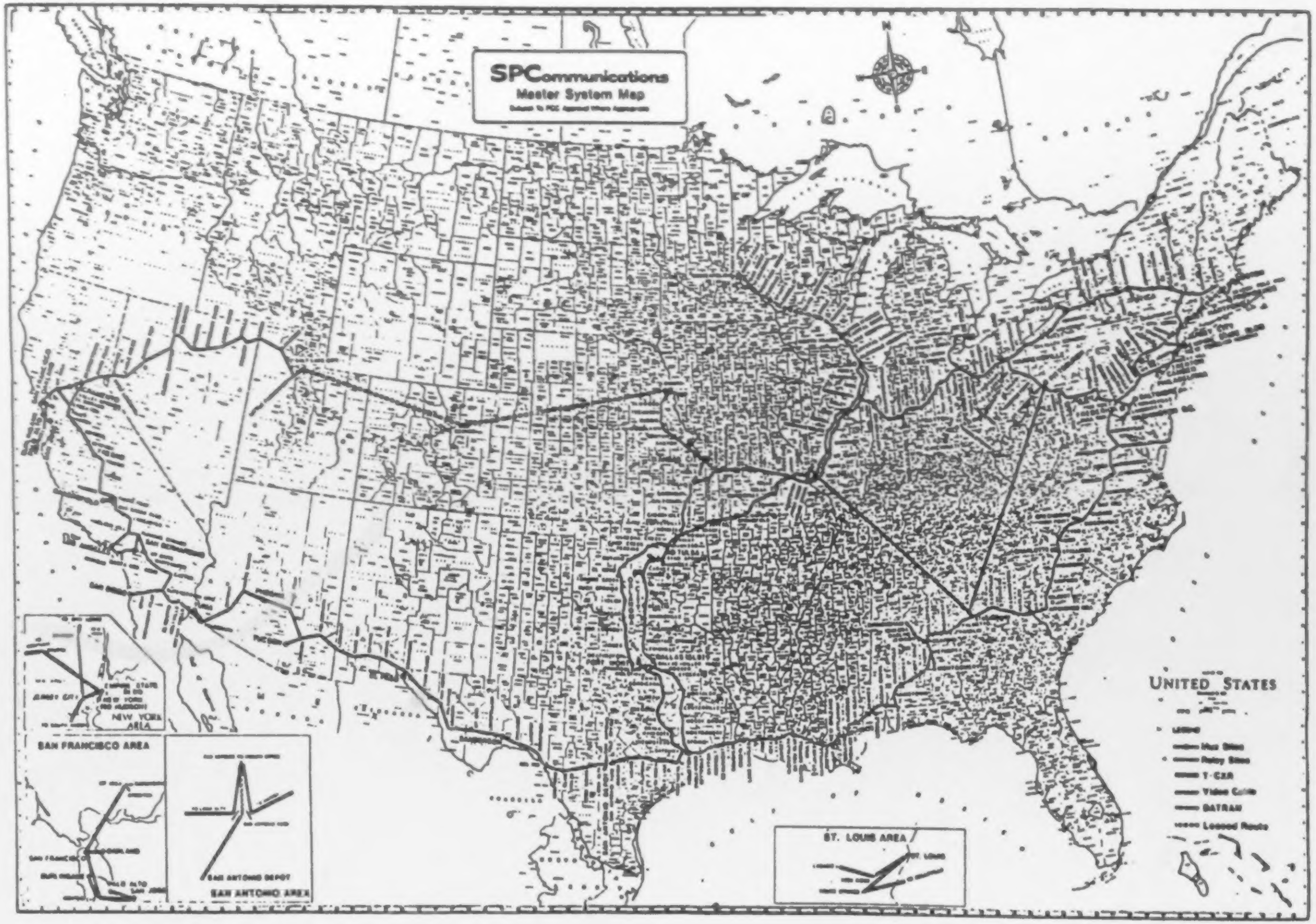
SPCC seriously questions whether legislation is appropriate at this juncture. The Government antitrust trial is in progress. Evidence is being produced and made public which is relevant to any legislative debate. AT&T is being given an opportunity to disprove the statements and contentions of the Justice Department. There is no urgent need for legislation. Waiting until the trial concludes would allow the Congress to have a complete record to act upon.

SPCC appreciates this opportunity to be heard and looks forward to returning soon to this Committee to discuss our experiences and dealings with AT&T over this past decade. We would appreciate the opportunity to discuss the structural issues in depth.


Employees: 927,000 (end 1976)
AT&T Co.
Bell Telephone Laboratories, Inc.*
16,000
Western Electric Co., Inc.
145,000
Teletype Corp.
Nassau Recycle Corp.
Sandia Corp.
General Departments
5,900
Long Lines Department
35,000
Bell Operating Companies
718,000
Bell of Pennsylvania
C&P Tel. Cos. (4 companies)
Cincinnati
Illinois
Indiana
Michigan
Mountain
New England
New Jersey
New York
Northwest
Ohio
Pacific NW
Pacific
South Central
Southern
Southern New England
Southwestern
Wisconsin
Diamond State
Other Subsidiaries
7,000
195 Broadway Corp.
American Bell International, Inc.
Transoceanic Cable Ship Co.
Transoceanic Communications, Inc.
TransPacific Communications, Inc.
Cuban American Tel. & Tel.
American Bell, Inc.
Eastern Tel. & Tel. (Nova Scotia)

*Ownership shared 50/50 by AT&T and Western Electric

FIGURE 1 ORGANIZATIONAL CHART, AMERICAN TELEPHONE AND TELEGRAPH CO. (THE HOLDING COMPANY)


SPCommunications
Master System Map
UNITED STATES
Relay Sites
Video Cable
DATRAN
NEW YORK AREA
EMPIRE STATE
NEW YORK
JERSEY CITY
SAN FRANCISCO AREA
SAN FRANCISCO
OAKLAND
PALO ALTO
SAN JOSE
SAN ANTONIO DEPOT
SAN ANTONIO AREA
ST. LOUIS AREA
ST. LOUIS

PREPARED STATEMENT OF HERBERT N. JASPER

RE: Competition in Intercity Communications

Mr. Chairman, we are pleased to have this opportunity to appear before the Committee on the Judiciary to discuss the state of competition in the telecommunications industry. The Ad Hoc Committee for Competitive Telecommunications (ACCT) is a non-profit industry association which was formed to preserve and enhance competition in telecommunications. Our group was organized in 1976, when the emerging competition in telecommunications was directly threatened by legislation before the Congress which would have enlarged and entrenched AT&T's monopoly in communications. That legislation was prepared by the established telephone industry; it would have overturned a series of FCC and Federal Court decisions and would have eliminated competition.

Communications Competition in Historical Perspective

From the issuance of the telephone patents in 1876 to their expiration in 1893-1894, Bell operated under a total monopoly. Extent and direction of expansion were controlled by Bell. It could establish prices at any level. Rural and suburban areas were virtually without telephone service. Stockholders' dividends in this period were at the fantastic return-on-investment rate of 46%.

With the expiration of the patents, the floodgates of competition were opened and an absolute monopoly was never again held by Bell. Within four years, 6,000 independent telephone companies were formed. This early competitive phase (1894-1906) saw a dramatic increase in the number of telephones in the U.S.

The competition was fierce and, due to the absence of any state or federal regulatory bodies, the industry did suffer some inefficiency. Some areas were served by two or even three competing, uninterconnected companies requiring individuals to subscribe to more than one service for "full service."

Eventually state legislatures and the Congress determined that the continued unrestrained competition would not bring further public benefits sufficient to offset the problems of financial weakness caused by expansion and the inconvenience and cost of uninterconnected systems in the same town. Some states established regulatory commissions as early as 1907 and some federal regulation was introduced in 1910 (the Mann-Elkins Act amendment to the Interstate Commerce Act). Regulation controlled the competition, brought about interconnection and established the principle of having a single franchised monopoly in each geographical area for telephone exchange service.

The later competitive phase (1907-1920) saw the growth of AT&T through acquisition; an end of the acquisition by the "Kingsbury Commitment" of 1913; the beginning of protection from competitors through exclusive franchises and guaranteed profits established by the Mann-Elkins Act of 1910. These events resulted in cartelization of the telephone industry by the 1920's.

To the casual observer, it may appear that competition died in the early 1920's (although some dual telephone service persisted into the 1940's), and has only reappeared with the FCC decisions of 1968 and after. This may be true for local telephone services but, in fact, there has been some competition for decades in large segments of the telecommunications industry.

The most obvious and pervasive has been the 100 years of competition between AT&T and the Western Union Telegraph Company. After initial confrontation, which ended in 1879, Bell became the dominant telephone carrier and Western Union established a monopoly over the domestic telegraph industry. Indirect competition existed whenever a consumer would substitute a telegram for a telephone call and vice versa. (New message services are now competing with the telephone.)

AT&T, for a time, offered TWX teletypewriter service in direct competition with Western Union's TELEX service. Currently, both Western Union and AT&T offer private line voice and private line telegraph channels in direct competition with one another. Since 1949, there has been direct and beneficial competition in the common carrier mobile radio service and among international record carriers. New carriers were authorized by the FCC in the 1950's to transmit video signals to cable television operators in remote areas which AT&T chose not to serve. By 1970, there were 59 of these. After a large video rate increase by AT&T in 1969, a number of these companies began to compete directly with AT&T(and new companies came into the business). One of them, Western Tele-Communications, Inc., now serves a number of larger cities such as Portland, Oregon.

The modern competitive era began in 1959 with the Above 890 MHZ Proceeding, after which radio frequencies were authorized for private microwave systems. A number of such private systems were built by the few organizations that had a sufficient volume of traffic between two points (and often their own right-of-way) to justify the construction of their own system, such as pipeline and railroad companies.

In its 1968 Carterfone decision, the FCC permitted the attachment of customer-owned terminal devices to the telephone companies' lines, provided such devices were not harmful to the network. This was followed in 1969 by the MCI decision in which the Commission approved (after six years of controversy and proceedings) the first application to build and operate specialized common carrier microwave facilities. This decision was followed by the 1971 Specialized Carrier decision, the 1972 Domestic Satellite decision, and the Resale and Shared Use decision in 1976.

ACCT Companies

We represent nine communications companies which operate in the long distance transmission business:

1. Specialized Common Carriers

    MCI Telecommunications Corporation
    RCA American Communications, Inc.
    Satellite Business Systems (SBS)
    United States Transmission Systems, Inc. (USTS)

2. Value Added or Resale Carriers

    Graphnet, Inc.
    GTE Telenet Communications
    U.S. Telephone Communications, Inc.

3. Miscellaneous or "Video" Carriers

    Midwestern Relay Company
    Western Tele-Communications, Inc. (WTCI)

They compete with each other and with the established common carriers (principally AT&T and Western Union) in offering a wide range of transmission services including voice, record, video, data and facsimile. ACCT is funded by dues and contributions from its nine supporting companies. Contributions have also been received from equipment and service vendors which are suppliers to transmission companies.

The categories of new competitors to AT&T, together with estimated total revenues for each group, i.e., both ACCT and non-ACCT companies, are set forth below:

Specialized Common Carriers (Estimated 1980 revenues, $400 mil.)

The Specialized Common Carriers (SCC's) are also referred to as Other Common Carriers (OCC's). They provide intercity voice and data communications services designed for corporate and government, as well as residential, users. They use their own terrestrial microwave transmission systems to provide long distance communications services which usually interconnect with the local telephone company at either or both ends. They pay the local telephone company for provision of such facilities.

Domestic Satellite Carriers

Domestic Satellite Carriers (Dom Sats) offer a wide range of communications services originally offered to business, government and the media, utilizing satellite transmission. These include voice, facsimile, and wide-band data services using dedicated earth stations and television transmission to cable television and broadcast companies. More recently, some of these carriers have made plans to offer switched-voice transmission services to the public, which are similar to those already offered by several of the terrestrial carriers.

Resale or "Value Added" Carriers (Estimated 1980 revenues, $75 mil.)

Value Added Networks (VAN's) typically offer specialized services (having added value) such as packet-switched data communications and facsimile transmission, utilizing computer based switching equipment (with a capacity to connect incompatible terminals) and lines leased from other carriers. More recently, there has sprung up a new resale industry which offers communications over lines leased from either AT&T or from SCC's and resells them to their customers with little or no value added, other than that which comes form the economies of "volume discounts", or least-cost routing programs.

Miscellaneous or "video" carriers (Estimated 1980 revenues, $40 mil.)

Miscellaneous Common Carriers (MCC's) relay, through terrestrial microwave facilities, television and radio signals, principally to cable television firms and broadcast stations.

Other competitors

ACCT represents a major portion of the new competitors in the long distance transmission business, but not the entire industry. Altogether, the competitive transmission business had estimated 1980 revenues of $625 million (excluding Western Union's terrestrial services.) In contrast, AT&T had estimated long distance revenues (domestic only) of $24.9 billion and the independents had toll revenues of $8.2 billion.

Major AT&T competitors which are not represented by our organization include Western Union which provides competitive services over its Westar Satellite (It also has substantial traffic in the TWX, telegraph, Mailgram and private line market); Southern Pacific Communications (an SCC); American Satellite Company (owned jointly by Fairchild Industries and Continental Telephone Company), a Dom Sat, which leases satellite circuits from Western Union; Tymnet, a VAN, (which is a subsidiary of Tymshare) and Eastern Microwave (an MCC). There are also more than a score of new resale companies, which have been established in recent months, and a like number of small MCC's. The resale companies have recently organized the Association of Long Distance Telephone Companies (ALTEL).

The categories of carriers enumerated above derive from the FCC authorizations. However, they no longer uniquely describe either the facilities used or the services offered. For example, some of the terrestrial microwave carriers lease intercity circuits from other SCC's, or from AT&T, in order to fill gaps in their networks and, thus, to reach cities which they could not otherwise serve. On occasion, terrestrial microwave carriers lease satellite circuits from Dom Sat carriers. Furthermore, some of the terrestrial carriers have received licenses from the FCC to construct and operate their own satellite transmission services.

It should also be noted that the General Telephone and Electronics Corporation (GTE), currently operates satellite transmission facilities, jointly with AT&T, but it has recently been authorized to construct and operate its own satellite system. Eastern Microwave, an MCC, is now transferring some of its television and radio program distribution services from its own terrestrial circuits to leased satellite circuits. It plans to convert part of its terrestrial microwave network to a wholesale transmission service suitable for leasing to SCC's for their voice and message transmission services. Finally, some of the new resale carriers are already making plans to construct and operate their own transmission facilities.

Relationship with the Bell System.

The SCC's do not lease any significant amount of intercity circuits from AT&T. However, they are dependent upon AT&T (or independent telephone companies) for local distribution if they wish to provide switched-voice services (such as MCI's Execunet, USTS's City-Call, Western Union's Metrocall and SPCC's Sprint). Thus, the Bell Operating Companies (BOC's) and the independents have control over "bottleneck" facilities, which they are franchised to construct and operate under state regulatory authority. (The interconnection is, however, subject to Federal regulation.)

In the aggregate, competitive long distance carriers now reach approximately 230 metropolitan areas. Although most of these are in Bell territory, there are a number of cases where an independent telephone company does provide the local connections. (It is interesting to note that AT&T and its advocates freely criticize the new competitors as "cream skimmers" because they now serve, principally, the larger cities, without taking note of AT&T's own cream skimming. AT&T serves 81% of the subscribers in 42% of the U.S. land area, while the independents serve 19% of the subscribers in 45% of the U.S. Bell, thus, enjoys a telephone density of 100 subscribers per square mile, compared to 21 for the independents.)

The quality, availability, and pricing of the interconnections with the BOC's has been a matter of great controversy. MCI was forced to vindicate its rights to Foreign Exchange (FX) and Common Control Switching Arrangements (CCSA) through protracted proceedings at the FCC and in the courts. (The denial by AT&T of these connecting arrangements has been a major issue in the MCI and U.S. antitrust suits against AT&T.)

Bell's Long Lines Department owns less than 20% of the nation's long distance plant. Most of the system is owned by the BOC's and only a small portion is owned by the independents. The kinds of connections which the BOC's provide to Bell Long Lines (and to the long distance circuits of the BOC's, themselves) are substantially different from and superior to those provided to the SCC's. For example, the SCC's are given a "line-side" or two-wire connection, no different from that provided to any other business customer whose office is connected to the local exchange by a local loop. In contrast, the long distance facilities of the established telephone companies are provided with "trunk-side" or four-wire connection to the local exchange company. This permits Bell to offer a higher quality of transmission service.

An additional difference in the interconnections provided by the BOC's to the SCC's is that direct distance dialing is available throughout most of the country, in both Bell and independent territory, regardless of whether the call is being placed on a rotary dial or tone-generating telephone. However, the BOC's have refused to give the SCC's the same character of interconnection, so that calls made on SCC lines are limited to tone-generating telephones (or rotary dial phones, to which a tone-generating appliance has been added). At present, more than 70% of the telephones in the United States are rotary, so that a substantial part of the market has been excluded from service by the competitive long distance companies.

Finally, there is the question of ten-digit dialing. Throughout the U.S., a customer can dial a long distance call with ten or eleven digits. However, the competitors' customers must dial 22 or 23 digits. (This includes an extra seven digits to dial the SCC's local computer and another five or six to enter the customer's authorization number.)

To date, Bell has refused to give the SCC's arrangements equivalent to its own. In fact, AT&T's Chairman, Charles Brown, stated last year at an appearance in the Washington area that "MCI will not get ten-digit interconnection." Yet this would seem to be mandated by the non-discrimination provisions of the existing law and regulations.

It is no surprise to note that Bell exploits this discrimination as a marketing tool. Bell system officials have warned customers about the great inconvenience they would experience if they chose to employ a competitor's 22-digit service.

All three issues -- four-wire connection, connection to tone telephones, and ten-digit interconnection -- are being discussed by Bell and the SCC's, under the aegis of the FCC. Likewise, the whole question of the rates charged for local interconnection is under consideration as the ENFIA (Exchange Network Facilities for Interstate Access) agreement of 1978 nears expiration. The telephone companies have sought a major increase in these charges for interconnection, alleging that the SCC's are not paying the full cost. On the other hand, the SCC's have pointed out that -- for the quality and character of the service actually being provided -- the SCC's are paying far more than the actual cost of the facilities offered. For example, according to AT&T's own figures, which have been presented to state regulators in a number of proceedings, the monthly charge for an access line provided a business customer is in the range of $16 to $26. However, MCI is paying $112 for an identical facility.

There is also the question of what services are provided by the BOC's to the long distance system. For example, directory assistance, billing and collection, and advertising are services which the SCC's provide for themselves but which its competitor, Long Lines, has provided for it by the BOC's. In the present state of AT&T accounting, there is no way to learn how much these services cost and, in turn, how much, if any, the long distance service pays for those services.

Turning to the Dom Sat carriers, many of their present services do not require direct interconnection with the local exchange companies. The initial business plans of SBS were to emphasize service from and to customer-premise earth stations, providing communications principally among various facilities of a given customer. However, a number of its customers have chosen to have SBS arrange, also, for direct connection to the local exchange. Other customers will share an earth station, and some of them will require direct connection. Finally, SBS also has plans to provide switched voice services to smaller customers through its own earth stations and will need the same sort of interconnections for that service as do the other SCC's.

RCA Americom's business is principally in the field of video distribution. But it, too, has announced its intentions to offer a switched-voice service. Unfortunately, the loss of its satellite, which was launched into orbit in December 1979, has slowed its entry into this market, as all of the available circuits were required to service its previous video customers.

The VAN's, such as GTE Telenet, Graphnet, and Tymnet typically lease their circuits from AT&T, although they also lease some circuits from SCC's. The new resale carriers include customers of the SCC's, but many of them are reselling AT&T circuits. The authority to resell WATs service should greatly increase the potential sales of such companies.

GTE Telenet's packet-switching technology provides for a more efficient, more economical and more reliable means of transmitting high volumes of data rapidly. AT&T had declined to adopt this technology when it was offered to it, and has spent the last several years announcing, and cancelling, its plans to offer a similar service -- the so-called Advanced Communications System.

In the case of Graphnet, the principal service offered is a hard-copy message service. This puts Graphnet into competition principally with Western Union, rather than with AT&T.

Equipment Supply

None of the ACCT members is an equipment manufacturer. Therefore, all of them purchase their transmission, switching, computer and other equipment from other communications suppliers. They supply much of their own computer soft-ware. Most of the equipment they purchase is manufactured in the United States, although some of it is imported.

Some of the equipment is manufactured expressly to the design of the SCC's. For example, MCI has just relocated its offices to a new building in Washington and has constructed a new terminal in that building (which is equivalent to a Class 4 toll office in the telephone industry). The terminal has an automated, remote test facility constructed by the ADC Corporation to MCI's design. The new test facility is the first of its kind in the industry and is a substantial advance over equipment and methods previously used. It is an example of the substantial cost savings which can be effected in a competitive environment. Other innovations have permitted MCI to construct its microwave networks for one-half of the costs incurred by AT&T and to operate those networks for approximately one-third of the cost to AT&T. There is, of course, another reason for AT&T's high costs. As a regulated utility, subject to an allowed rate-of-return-on-investment method of regulation, it is the leading example of the "Averch-Johnson effect." This describes the tendency of regulated utilities to "gold-plate" their facilities, since their rate-of-return, or profit, is a percentage of their investment.

SBS has also contracted with AM International for the development of equipment for high-speed, bulk document distribution. This has resulted in equipment offering transmission of documents at about one page per second, with quality exceeding that of other, and slower, systems.

The introduction of competition provides a brand new set of incentives for competitors to keep costs down through innovation and efficiency. It is these advantages which have given the specialized carriers a competitive edge against the Bell system, an edge which AT&T now seeks to deny through gaining effective control over a new access charge system under which it hopes to handicap its competitors.

Senator DeConcini. Our next panel will be composed of Robert G. Marbut, American Newspaper Publishers Association; Howard Liberman, attorney, representing the views of information providers in the videotex industry; and William Koch, Alarm Industry Telecommunications Committee.

Gentlemen, please come forward.

Your full statements will be included in the record at the completion of your oral presentations. Please summarize them for us.

STATEMENT OF ROBERT G. MARBUT, PRESIDENT AND CHIEF EXECUTIVE OFFICER, HARTE-HANKS COMMUNICATIONS, INC., SAN ANTONIO, TEX.

Mr. Marbut. Thank you, Mr. Chairman.

I appreciate the chance to be here.

I am Bob Marbut. I am president of Harte-Hanks Communications, which is a communications company headquartered in San Antonio.

Our primary business, although we are in several of the media, is newspapers.

I would like to comment, particularly, on this whole area of electronic information services.

The technology to bring electronic information services is already in place—the terminals, the two-way distribution system, and the computer. However, the market itself is still in its infancy. It is still very fragile.

We believe that this new electronic information services medium has three segments. Each segment has unique characteristics. These individual characteristics of each segment must be taken into account in the development of public policy in this new area, particularly as it impacts A.T. & T. and what its role will be.

The first segment involves the customer terminal. This is an area of rather vigorous competition today.

The second segment or element is the transmission network itself—the two-way interactive electronic link between terminal and data base.

Today, and for the foreseeable future, there is only one system available that is capable of reaching virtually every home and business. That is the local monopoly telephone system and its national interconnected network.

The third segment is the provision of information itself. It is quite different. This part can be, and should be, highly competitive.

The telephone system makes it possible to dial up an endless number of data bases from virtually an unlimited number of electronic publishers. This diversity of information providers is possible, however, only if public policy is developed to foster such variety and competition.

To help achieve this, my colleagues and I believe that the 47-year old Communications Act should be modernized. We believe that the goal of public policy in this area should be full and fair competition from the widest possible diversity of sources, free from regulation wherever possible.

When one analyzes the three segments necessary to develop electronic information systems against these public policy goals, it becomes easier to understand that full and fair competition can develop only if the company that controls the monopoly conduit does not also provide the information content.

This is still a fragile industry. Electronic information services for a long time will be a risky business, looking at this business alone.

If one competitor enters the market with clearly the unfair advantage that is implicit in what we have just talked about, it will deter others.

A dominant telephone company that can provide information over its own monopoly lines, where it is the only one that controls both content and conduit, has such an advantage.

This problem is particularly serious in the case of A.T. & T. which essentially controls 80 percent of this distribution network.

Since A.T. & T. makes money in its monopoly network, its information service can charge its customers less than other competitors would have to charge. This is because A.T. & T. would be the only player in the market which is totally vertically integrated from the information-providing area, all the way through the customer terminal area.

A.T. & T. has a gigantic assured flow of income from its monopoly operations which have a guaranteed rate of return. A.T. & T. can use this, plus its other resources, such as research, to subsidize its information service activity.

A.T. & T.'s natural incentive would be to favor its own information service, particularly when some bottleneck condition exists.

There are other examples, but I hope this makes the point. There is great difficulty, even with antitrust laws and even with existing regulatory oversight—which may even lessen if things change in that area—in protecting others against such anticompetitive behavior.

These problems can be avoided. The public can be served, and A.T. & T. can still participate in this new business in a meaningful way if a sharp line is drawn between content and conduit.

There should be separation between those who provide information content and the supplier of monopoly telephone services in a local market. However, A.T. & T. would have a key role to play. They would provide the crucial transmission services and make money from the access charges. This should help to keep local telephone rates lower than they would otherwise be.

A.T. & T. also would be among those providing terminals. In fact, they would probably become a major factor in this area.

If you put these two things together, it is not hard to predict that A.T. & T. would probably become the biggest player anyway in this electronic information services area.

A.T. & T. could still provide information services through all other channels where it does not have the monopoly distribution system.

We also believe that this diversity principle should apply to all types of information—from hard news to advertising. We think that this proposal is the best way to provide the public with the maximum benefits of this exciting new medium. It will stimulate competition from over 20,000 print publishers who exist today, and it will entice new entrants—people who are not publishers today—who never before had been in this industry. It will make possible fair competition, and it will insure diversity.

Thank you.

Senator DECONCINI. Mr. Liberman, will you proceed with your statement before we ask questions?

STATEMENT OF HOWARD M. LIBERMAN, ATTORNEY, REPRESENTING VIDEOTEX/TELETEXT INFORMATION & SERVICE PROVIDERS, WASHINGTON, D.C.

Mr. LIBERMAN. Thank you, Mr. Chairman.

My name is Howard Liberman. I am a Washington attorney working on behalf of a number of information providers and service providers in the videotex/teletext area to organize a trade association.

Believe it or not, you are dealing with an industry that is so new it does not even have a trade association.

Working with me on the project, and with me this afternoon, is Mr. Gary Arlen, president of Arlen Communications, Inc., publisher of the International Videotex Teletext News.

Mr. Arlen is one of the Nation's leading experts in videotex/teletext. In addition, he is an information provider. His monthly newsletter is included as part of a videotex data base in the United Kingdom.

Videotex and teletext are sometimes also referred to as "data base publishing" or "electronic publishing". What we are talking about is the ability of a business or a home consumer to obtain information or affect transactions.

The term teletext refers to a one-way service sent over the air waves as part of the signal of a television broadcasting station—or, perhaps in the future, as part of a direct satellite-to-home station.

A number of frames—say 200 to 300—is continuously cycling on the teletext signal. By means of a device connected to a standard television set, the user is able to choose which frame or page to view, starting in most cases with an index.

Videotex is a two-way service. With videotex, the user actually has access to the data base, either to choose information, like teletext, or to send information, such as ordering from an electronic catalog or affecting funds transfers.

There are three types of information providers or service providers in these areas. First are the publishers of periodicals who choose to make their publications available electronically. The periodicals could be daily, weekly, monthly, or of any other frequency.

The idea is that in this category, the publication is fixed every so often and available in that form electronically until the next issue replaces it in the data base.

With videotex, because it is two-way, the subscriber could also access back issues or even research by subject—for example, request all stories on a given subject in the past four months.

The latter is really more like the second category of information and service providers—a continually updated data base.

Examples of this latter category are a weather service; a news, sports, or stock ticker service; or the official airlines guide.

Another fairly well-known example is Lexis, a legal research service, which is continually being updated, rather than fixed every so often like a periodical.

The third category of information and service provider is the transactional service where the transaction is being marketed rather than just the information.

Two examples of this category are the electronic catalog with the ability to order products or services and electronic funds transfers.

It is important to bear in mind that throughout all three categories of information and service providers that I have just mentioned, there are three types of audiences or markets. First is the general audience—the potential consumers of an electronic daily newspaper, weather, or sports service or a shop-at-home electronic catalog.

Next are the specialized audiences, such as a special interest periodical or a specialized data base. I have already mentioned Lexis, which is a research service available for lawyers.

Finally, there is what I will call the restricted access markets, such as credit information, which would only be available to businesses, or the ability to order prescriptions, which would be available only for doctors.

I have given the general description of what teletext and videotex information providers can do. The question is what are they doing.

The answer to that question is that these services, for the most part, are being provided in this country on a very limited, experimental basis. It appears to me that many law offices subscribe to Lexis, but this may be the only videotext market in this country with significant penetration.

According to statistics Mr. Arlen has compiled, the Source, which is a general appeal data base, has fewer than 15,000 subscribers in the entire country. A Dow Jones news retrieval service has perhaps 18,000 subscribers, most of whom are in brokerage offices.

Last month, Mr. Arlen and I attended the National Cable Television Association convention, where videotex was a major topic, and a special videotex conference in Toronto. Our conclusion from those conferences is that there is a great deal of excitement about the technology but caution about the business potential. Part of this caution stems from the fact that the only effective means of conducting two-way videotex services is through the telephone network. The telephone company is feared as a potential service provider, as well as the only channel of delivery.

In a very few communities, there are cable television systems with two-way capability sufficient to conduct videotex services. However, this by far is the exception.

Perhaps in the future, enough homes will subscribe to two-way cable television in some communities so that the telephone company will not be the only game in town for videotex service providers. Then the question will be whether the cable system operators must afford access to others, or whether cable operators may contract with some providers and exclude all others.

In the meantime, there is a concern now—in some cases, even a fear—among information and service providers that if telephone companies are permitted now to become information and service providers for videotex services, it will discourage the innovation, experimentation, and development of new services by the others.

There is one striking example which I will give from my prepared testimony of the potential effect that telephone company ownership could have on the fledgling videotex industry.

Assume that a given service—say, a sports ticker service or sports scores—costs the telephone company and an independent entrepreneur the same to produce. In a competitive environment, the telephone company could offer the service at cost and still make a profit on the message units users would incur in accessing the service.

While the telephone company could afford to maintain this status as long as necessary, obviously, an independent entrepreneur could not compete very long by offering its service at cost or offering its service at a higher price.

In conclusion, it should be our national policy to create a competitive market for new telecommunications services, both informational and transactional, general and specialized.

There is a fear among new and potential service and information providers that if A.T. & T. enters this market, there will not be a favorable environment, either financially or technically, for the introduction of these services.

Thank you.

Senator DeConcini. Mr. Liberman, thank you very much.

There is a vote on the Senate floor, and I am going to have to excuse myself. The chairman will make an effort to be here sometime this afternoon.

In lieu of his inability to be here and the necessity that I leave at this time—not only to vote but to attend another meeting—under the rules of the Senate Judiciary Committee, the testimony will be taken by the staff.

Mr. Koch, please proceed with your statement.

STATEMENT OF WILLIAM P. KOCH, CHAIRMAN, ALARM INDUSTRY TELECOMMUNICATIONS COMMITTEE, WASHINGTON, D.C.

Mr. Koch. Thank you, Senator.

I am Bill Koch, president of Certified Alarm and Signal Co. in Toledo, Ohio, and chairman of the Alarm Industry Telecommunications Committee.

AITC was formed 2 years ago to bring the telecommunications deregulations concerns of the alarm industry to the attention of Congress and the Federal Communications Commission.

AITC is composed of representatives from the alarm industry trade associations and represents a position supported by more than 8,000 companies engaged in various aspects of the alarm industry.

We support congressional efforts to increase competition in telecommunications. We are a highly competitive industry now, and we believe that such competition benefits the consumer with technological innovation and lower prices.

However, we are opposed to overly broad, indiscriminate deregulation of A.T. & T., since such deregulation will not enhance competition; rather, it will stifle it.

The alarm industry's specific concerns with regard to telecommunications deregulation are twofold.

The FCC and State regulatory authorities continue to have jurisdiction over common carrier facilities for which there is no reasonable available alternative.

Two, congressional restructuring of the Bell System should not give A.T. & T. anticompetitive power to wipe out the present alarm service industry through an overly broad legislative waiver of the 1956 consent decree.

The alarm industry has a symbiotic relationship with A.T. & T. and other telephone companies. It is, and will continue to be, totally dependent upon the telephone company-provided leased lines for the provision of its services.

The highest quality of service that is needed by banks, jewelers, and defense establishments requires constant monitoring of the premises and constant supervision of the status of the transmission link between the protected premises and the central monitoring station.

In order to provide such a service, an alarm company must lease private lines from the local telephone company. Through these lines, the alarm company sends a signal which it constantly monitors. If there is ever any change in the status of this signal, the alarm company is warned that something may be amiss. Only a direct link, because of its constant nonfluctuating nature, is capable of being so supervised.

If a burglar were to cut an ordinary telephone line before burglarizing a business, no one would know of the broken communication link until an attempt were made to place an outgoing call. Then, of course, it would be too late.

On the other hand, if an electrical link—private line—were cut, the central monitoring station would be immediately alerted.

Technological leads have developed a myriad of smoke, fire, and intrusion detection devices. The only form of noncompromisable transmission remains the electrical link via private leased lines from the telephone companies. These lines are not available from alternative suppliers.

The alarm industry is dependent upon telephone company-provided facilities. Data processors, computer companies, and others have satellite and terrestrial transmission alternatives. Alarm companies do not.

On a local loop basis, no alternative system is available for private leased lines in today's market.

It is interesting to note that the alarm industry has not always been dependent upon the telephone company's leased lines. The alarm industry predates the telephone industry. At one time, it was the alarm industries and alarm companies which owned the wire lines and leased them to the telephone company. An alarm company central station served as the first telephone company exchange.

Dependence resulted when the telephone companies became governmentally sanctioned monopolies and providers of common carrier service and agreed to operate as regulated entities.

As you can see, if legislation were enacted which did not provide for continued regulation of private lines, our industry could be killed by arbitrary telephone company decisions to discontinue the provision of such lines and/or to raise the rates so ungodly high that you could not afford them.

Congressional consent to an unregulated entry by A.T. & T. into the alarm business would wipe out the present industry which is primarily made up of comparably small companies.

Because of the intimate working relationship the alarm industry has always had with the telephone company in the linking of the protected premises to the central station, A.T. & T. and the other telephone companies not only know our operations inside and out, but they even know our trade secrets and the identities of all of our customers.

Since the alarm industry will continue to be totally dependent upon the telephone company-provided facilities, it is only proper that the telephone companies be precluded from the favorable position of offering both common carrier and customer service. Such integration would be contrary to both economic theory and the antitrust laws.

The alarm industry suggests that if Congress decides it is in the public interest to allow A.T. & T. to enter unregulated business, then legislation should be drafted which provides for a limited waiver of the 1956 consent decree to address specific competitive concerns.

There is no rational basis for an overly broad legislative waiver that encompasses alarm services when the alarm industry poses no competitive threat to A.T. & T. and when the alarm industry is not eroding any A.T. & T. market and is definitely a segregable industry.

As was done in last year's House of Representatives domestic common carrier bill, which was approved by that Chamber's subcommittee and full committee, any deregulatory measures should preclude A.T. & T. from providing alarm services in its service areas.

A similar consent decree waiver exemption presently exists in legislation now being considered by the Senate Commerce Committee for cable television and mass media services.

In the alternative, the alarm industry suggests that any legislative consent decree waiver look to the expertise of the Federal Communications Commission and give the Commission authority to apply the waiver on a service-by-service, market-by-market basis should it determine that competition from A.T. & T. would be in the public interest.

Thank you.

Mr. CHUMBRIS. Thank you, gentlemen.

This is not an unusual procedure for staff to take over once a hearing has begun. Even though we have quite a few members of the committee, each of them had another responsibility. That is why Chairman Thurmond could not be here.

At this time, Marcy Tiffany, the counsel who is in charge of this particular hearing and investigation, will now ask you some questions.

Ms. TIFFANY. Mr. Marbut, do you have any indication of whether A.T. & T. is planning to enter the information market if they were granted the right to enter unregulated markets?

Mr. MARBUT. I guess the most tangible indication would be the combination of experiments they have already been involved in, such as in Albany, N.Y., where they were testing certain areas, such as the directory service, and in Coral Gables, Fla., where they have been in partnership with Knight Ritter Communications. They were providing equipment and the transmission network there. And their application in Austin, Tex., to provide what they call EIS-II, which would be a test of many different kinds of things.

The indication in their application was that they would be doing all of this. This included electronic publishing of advertising information of all sorts.

Ms. TIFFANY. Would you explain how the information services would be marketed? Would the newspaper companies simply be providing the information, or would they be selling the whole system of prearrangements with the carrier and with the equipment?

Mr. MARBUT. I think it would be interesting to just one more time mention that the newspaper industry is composed of about 1,750 daily newspapers and about 7,600 weekly newspapers and over 10,000 magazine and periodicals.

There are hundreds and hundreds of other newsletters and shoppers and other kinds of print media that all potentially may want to be an information provider over one or more systems in one or more data bases.

Newspapers are only one part of this market.

Newspapers will be doing it in different ways. Some newspapers are very large, and some are very small. The ones that are very small will probably want to use someone else's computer, except for just the minimum amount of activity. They would not own it; they would actually be an information provider—an electronic publisher—very much the same as a magazine publisher is today where they use someone else's press and someone else's distribution system.

Others, such as Knight Ridder in their experiment with A.T. & T. in Florida, would use their own computer system but depend on the local telephone company for the distribution of that and depend on others to sell terminals in the homes.

By the way, that partnership in Florida, we think, is a very good model for how A.T. & T. can benefit from this service and yet how they are not actually providing information over the system.

Ms. TIFFANY. Thank you.

Mr. Liberman, you mentioned three types of markets for videotex services—individual consumers, specialized audiences, and the business market.

I know this industry is in its infancy, but where would you expect to be the greatest growth in these three different markets?

Mr. LIBERMAN. The people entering the industry on the large scale hope that the biggest growth is in the consumer area, just because the numbers are greater. Lexis, the service for attorneys, seems to be doing quite well from an outsider's point of view because so many law firms subscribe. Therefore, as I say, they may have a high penetration.

The problem is that the specialized services may have to charge so much that they will not have enough customers to recoup what it takes to put together the package. The growth may be more in some kind of what I would call a menu or a group, such as the Source, which has a number of different information bases in the menu. Any number of people might subscribe—an office, a home, a stockbroker, or a research library. Any number of people might subscribe to that one service.

Ms. TIFFANY. You mention in your written statement that when cable television was first coming onto the market, the FCC kept telephone companies out of the cable system ownership. Do you know if that is still the case?

Mr. LIBERMAN. Yes. At the moment, a telephone company may not own a cable television system in the area it serves, except upon receipt of a waiver from the FCC. The waivers are only granted in rural areas where the telephone company can show that there would not be cable television service, except if it were provided by the telephone company.

Ms. TIFFANY. Thank you.

Mr. Koch, how many telephone lines are involved in offering burglar alarm systems? Is it one for each alarm or one for each burglar alarm company, or is there some other configuration?

Mr. KOCH. As an example, in my company in Toledo, at the present time our company, which is a small company which is family-operated—my father, my brother, and myself are the sole stockholders—we serve only the Toledo, Ohio, area.

Our company uses 2,500 local loops. A loop would be required, for example, if the central station which is manned 24 hours a day is located—using the Washington, D.C. area—in the George Washington University area, and we wanted to have an alarm system on this room. It would require that we would have to have a local loop from this building or this room connected to our own customer-provided equipment.

We get no equipment whatsoever from the telephone company; we provide all of the equipment in this room. All we would get would be a piece of wire from here to the local exchange, and then from the local exchange we would have another piece of wire to the alarm company's receiving headquarters.

We put in all of the power on the lines. We use no power from the telephone company; we use only the wire. We use no switching gears; we use none of their computers.

The alarm industry originally provided the wires to the telephone company, because the logic that Alexander Graham Bell and Watson had was that you only use the wire at night when the burglar alarm is turned on; let us use it during the day for telephone service.

That is exactly what we do.

Our company, on a local basis, provides about one-quarter of our gross income to the telephone company in paying for these 2,500 local loops.

In 1976, we were able to procure a local loop from the local Ohio Bell Telephone Co. for a rate of $7.20.

The Public Utilities Commission in Ohio granted Ohio Bell a rate increase in late 1976 that brought that line from $7.20 to $29.75, a 313-percent increase.

In 1980, they granted an increase again on that same local loop to $43.60. In less than 5 years, the telephone line charge for a local loop in Ohio Bell went from $7.20 on a particular example to $43.60, which is over a 500-percent increase.

They not only get us there now, but it would be a disaster if they were allowed to be in this business.

Ms. TIFFANY. And this is just for use of the wire only.

Mr. KOCH. Yes. We use no switch network; we use no power. We use nothing of it but a piece of wire.

Ms. TIFFANY. You mentioned earlier the fact that the alarm industry originally had its own lines. What happened to that? Were you required to turn them over or what?

Mr. KOCH. If you go back into the late 1800's into the late 1870's, security was as much of a need then as it is now. People were breaking into homes and stealing the silver and so forth that we have going on today.

The need for an alarm system to be transmitted to a remote location, rather than just ring a bell on a building, was a very real thing.

Unfortunately, the pictures that we have of the late 1800's show thousands of lines being strung from rooftop to rooftop. It was a real spider's nest.

Somebody decided that somebody should do this on a regulated basis, and that somebody was the telephone company.

Ms. TIFFANY. So were your lines turned over? Did you have a sale of your lines to A.T. & T.?

Mr. KOCH. At that time, the alarm companies just quit using them and starting using the telephone companies' embedded plant. Eventually, as customers moved or left the service, the lines came down.

There are some companies. I know of a small independent company in Danville, Ill., that still has some of its own lines up, but there are very few any more.

Ms. TIFFANY. Is there any prohibition on you using your own wires and putting in your own lines?

Mr. KOCH. Now there is. Of course, there are prohibitions now because of the city ordinances and rights of way and so on. Now the biggest prohibition is trying to economically do it. It would just be unreasonable.

Mr. CHUMBRIS. Thank you very much, gentlemen.

Your entire prepared statements will be made a part of the record at this point, without objection.

[The prepared statements of Messrs. Marbut, Liberman, and Koch follow:]

PREPARED STATEMENT OF ROBERT G. MARBUT

Mr. Chairman, members of the Committee, my name is Robert G. Marbut. I am president and chief executive officer of Harte-Hanks Communications, a communications company, publicly owned, listed on the New York Stock Exchange, and involved in daily and weekly newspapers, radio and television, shoppers and distribution systems, cable television, marketing, support services and commercial printing. The company had operating revenues in 1980 of $303 million, and net earnings of $22.6 million. I serve on the boards of directors of several national, regional and state newspaper organizations -- among them The Associated Press and the American Newspaper Publishers Association. I also serve as the chairman of ANPA's Telecommunications Committee.

I appreciate the opportunity to share with you my views on AT&T's role in the electronic information marketplace. I will begin by explaining how we see this market developing and will then discuss our concerns about AT&T's role.

In the electronic information service of the future, the consumer will use a home terminal to display "pages" of information that are transmitted electronically. The pages are stored in a computerized "library," called a data base, that may be in the same town or another part of the country. The consumer pushes buttons to signal the computer the page he wants to see, and the computer then flashes that page to the consumer's terminal. (The terminal could be an adapted television set or a home computer or any number of compatible video devices.)

Each computerized data base may contain hundreds of thousands, or even millions, of information pages. Many such data bases may be available. Thus, these systems can give people rapid access to the precise items they want from a vast library of information. The information to be provided may include editorials, news, sports, weather, financial data, movie and restaurant listings, advertisements, research data, and so on. In addition to information, these systems may provide computer games, home banking, electronic mail, etc.

The cost of this service should be low. Consumers may use their television sets to display the information, and the additional equipment needed may cost less than $100 when in mass production.

Most of the technology to support these services -- the telephone network, the computer, and the basic terminals -- already exists. However, this market is in its infancy, and we think it will take years to develop fully. Eventually, electronic information services may become a crucial medium of mass communication.

We in the newspaper business welcome this development. For 200 years, we have been providing people with information to people. We will continue to do that job, utilizing the new technology to serve the public more effectively. Newspapers have been actively involved in the experiments around the country in electronic information services. I will be glad to supply more information in writing on those experiments if the Committee would like it.

The electronic information market has three distinct segments. One is the home terminal. This is simply another product for the vigorous and competitive electronic manufacturing industry that produces telephone instruments, television sets, home computers, and similar equipment. The second element is transmission -- the electronic link between the home terminal and the data base. For the foreseeable future, local monopoly telephone lines will be the crucial means of distributing electronic information to the general public. Only the telephone network provides a two-way service to almost every household. (Two-way service is needed so the user can tell the computer which pages to transmit.)

The third segment is the information provider, and its characteristics are very different. This part of the business can and should be highly competitive. Because the individual can use his telephone to dial up an unlimited number of data bases, and each data base can contain a wide variety of information, the technology allows an unlimited number of "electronic publishers."

The policy issue is whether that potential for diversity will be realized or killed.

During the past year, I joined many others in the newspaper business in a comprehensive review of telecommunications common carrier issues and of legislative and administrative proposals that had been advanced to address them. Our review found that legislation is needed to modernize the law to reflect the great technological changes since the Communications Act was written 47 years ago. We assumed that the goal of public policy should be to establish full and fair competition in the provision of information -- from the widest possible diversity of sources -- over the common carriers' telephone networks.

Consistent with the traditional independence of the press from government control, we began with the presumption that there should be no regulation of electronic information services. However, as we came to understand the telephone industry, we realized it is unique and requires a unique set of ground rules. It became apparent that full and fair competition can develop only if the company that controls the monopoly telephone conduit does not also provide the information content.

We call this concept "the diversity principle." I will explain why we feel it is essential.

Electronic information services are embyonic; they are risky ventures for any information provider. Diversity in this new medium can flourish if electronic publishers see a decent chance of succeeding. If one competitor enters the field with an unfair advantage, however, others may be unwilling to enter the market. A telephone company that can provide information to the public over its monopoly transmission facilities has just such an advantage. This problem is particularly serious in the case of AT&T, which serves 80% of the nation's telephone subscribers.

Until recently, AT&T has not been considered to be a potential entrant in the information publishing market because of the 1956 Western Electric antitrust consent decree. The continuing application of that decree now has been called into question, and it has become necessary to consider what problems may arise if AT&T becomes an electronic information provider.

Let me give you some examples of how AT&T could discriminate against competing information providers:

-- AT&T will make money whenever its telephone network is used. It makes money when a consumer uses AT&T's information service and when he uses someone else's service. That means AT&T can charge less for its information service than competitors, and that advantage can hurt competition.

-- AT&T has a huge, assured flow of income from its monopoly operations, which have a guaranteed rate of return. It can use that money -- and the massive research and management base it supports -- to subsidize its competitive information provision service.

I can give you more examples, but I think the point is clear. AT&T's control of the monopoly telephone lines would give it a huge competitive advantage over other information providers who have to rely on those lines. The antitrust laws and regulatory oversight provide some protection against this kind of anticompetitive behavior. But it is extremely difficult to scrutinize the activities of a company as large as AT&T. Moreover, reliance on antitrust litigation and regulatory oversight will create an endless tangle of legal proceedings. All those problems can be avoided -- with no loss in service to the public -- by drawing a sharp line between content and conduit for electronic information service.

This proposal is based on the fact that content and conduit are very different businesses. Local telephone transmission service:

-- is capital intensive;

-- has very high economic entry barriers;

-- should be technologically standardized;

-- depends on advances in computer and telecommunications technologies for innovation; and,

-- is subject to government regulation.

In contrast, the origination of information content:

-- is labor intensive;

-- has relatively a low economic entry threshold;

-- is characterized by flexibility and change;

-- is relatively independent of technological developments; and,

-- is not, and should not be subject to any government regulation.

National policy should therefore treat these two businesses differently. With regard to telephone transmission services, policy should encourage:

-- capital investment;

-- lower entry barriers;

-- standardization; and,

-- technological innovation.

At the same time, we must maintain the regulation needed to protect customers of monopoly facilities.

Policy affecting content origination, on the other hand, should foster:

-- competition;

-- investment in human resources;

-- entrepreneurial opportunity; and,

-- creativity.

Any direct government involvement in or regulation of content should be avoided.

The diversity principle calls for a separation between those who provide the information content and the supplier of telephone services in order to achieve all of these goals.

This proposal recognizes that telephone companies have a key role to play in the information market. First, they will continue to provide the crucial transmission services. Second, the development of electronic information services depends on having large numbers of terminals in place in homes and businesses. The telephone industry's expertise in terminal equipment is needed to develop the "critical mass" of terminals required to permit a wide variety of electronic information services. Accordingly, telephone companies should be a major factor in the provision of those terminals, a market which most observers agree will be vast and profitable.

Finally, the "diversity principle" would not prevent AT&T from originating information. AT&T could distribute printed material or use the electronic transmission channels of others. For example, AT&T would be free to advertise or express its opinions on television. The restriction applies only to content transmitted on AT&T's own lines.

We believe that the "diversity principle" should apply to all types of information -- for example, to advertising as well as news. Competition is important for advertising, and it is difficult and dangerous for the government to try to draw a line between news and advertising.

Some have suggested that our proposal might deprive the public of services. As I have indicated, electronic publishing is a business with easy entry. If fair competition is allowed, there will be plenty of entrepreneurs ready to provide every electronic publishing service the marketplace demands.

Some have suggested that the newspapers are trying to avoid competition. To the contrary, we welcome it. In the future electronic information business, we will be competing with a wide variety of other electronic publishers. Our proposal is designed to foster that competition.

Congress has devoted great time and effort in setting national policy for telecommunications. We support that effort and believe legislation is needed. If legislation is written to ensure fair competition, this new information medium will be diverse and competitive. It will make available to the American public the vast range of ideas and information that the new technology makes possible.

PREPARED STATEMENT OF HOWARD M. LIBERMAN

Good afternoon Mr. Chairman and Members of the Committee. My name is Howard Liberman. I am a Washington attorney working on behalf of a number of information providers and service providers in the videotex/teletext area to organize a trade association. Believe it or not, you are dealing with an industry that is so new it does not even have a trade association.

Working with me on the project, and with me this afternoon, is Mr. Gary Arlen, President of Arlen Communications, Inc., publisher of the International Videotex Teletext News. Mr. Arlen is one of the nation's leading experts in videotex/teletext; in addition, he is an information provider -- his monthly newsletter is included as part of a videotex data base in the United Kingdom.

Videotex and teletext are sometimes also referred to as database publishing or electronic publishing. What we are talking about is the ability of a business or home consumer to obtain information or effect transactions. The term "teletext" refers to a one-way service, sent over the air waves as part of the signal of a television broadcast station (or, perhaps, in the future, a direct satellite-to-home station). A number of future, part of a direct satellite-to-home station). A number of text signal, and by means of a device connected to a standard television set the user is able to choose which frame or page to view, starting in most cases with an index. Videotex is a two-way service. With videotex, the user actually has access to the data base -- either to choose information (like teletext) or send information, such as ordering from an electronic catalog or effecting funds transfers.

There are three types of information providers or service providers in these areas. First are the publishers of periodicals who choose to make their publications available electronically. The periodicals could be daily, weekly, monthly or any other frequency; the idea in this category is that the publication is fixed every so often, and available in that form electronically until the next issue replaces it in the data base. With videotex, because it is two-way, the subscriber could also access back issues, or even research by subject -- for example, request all stories on a given subject in the past four months. The latter is really more like the second category of information/service providers: a continually-updated data base. Examples of this latter category are a weather service; a news, sports or stock ticker service; and the Official Airline Guide. Another fairly well-known example is Lexis, a legal research service, which is continually being updated rather than fixed every so often like a periodical. The third category of information/service providers is the transactional services, where the transaction is being marketed, rather than just the information. Two examples of this category are the electronic catalog, with the ability to order products or services, and electronic funds transfer.

It is important to bear in mind that throughout all three categories of information and service providers I have just described there are three types of audiences, or markets, for these services. First is the general audience -- the potential consumers of an electronic daily newspaper, weather or sports service, or shop-at-home electronic catalog. Next are specialized audiences, such as special-interest periodicals and specialized data bases. (I've mentioned Lexis, a research service for lawyers.) Finally, there is what I'll call the "restricted access" markets -- such as credit information, which would be available only to businesses, or the ability to order prescription drugs, which would be limited to doctors.

I've given a general description of what teletext and videotex information and service providers can do. The question is what are they doing. The answer to that question is that these services for the most part are being provided in this country on a very limited, experimental basis. It appears to me that many law offices subscribe to Lexis, but this may be the only videotex market in this country with significant penetration. According to statistics Mr. Arlen has compiled, The Source, a general-appeal data base, has fewer than 15,000 subscribers in the entire country; a Dow-Jones news retrieval service has perhaps 18,000 subscribers, of which more than 80 percent are brokerage offices. Last month, Mr. Arlen and I both attended the National Cable Television Association convention, where videotex was a major topic, and a special videotex conference in Toronto; our conclusion is that while some U.S. companies are actively planning to market videotex services, others are stating publicly that the market is not there -- that consumers will not be willing to pay enough to make these services feasible. There is a great deal of excitement about the technology, but caution about the business potential.

Part of this caution stems from the fact that the only effective means of conducting two-way, videotex services is through the telephone network, and the telephone company is feared as a potential service provider as well as the only channel of delivery. In a very few communities, there are cable television systems with two-way capability sufficient to conduct videotex services, but this by far is the exception, even among the 24 percent of the nation's homes that are wired for cable. Perhaps in the future, enough homes will subscribe to two-way cable television systems in some communities so that the telephone company will not be "the only game in town" for videotex information and service providers. (Then the question will be whether the cable system operators must afford access to others, or whether they may contract with some providers and exclude all others.) In the meantime, there is a concern -- in some cases a fear -- among the information and service providers with whom I have consulted that if telephone companies are permitted now to become information and service providers for videotex services, it will discourage the innovation, experimentation and development of new services by others.

Our nation's policy has always been to encourage pluralism in the creation and sale of ideas. At this early stage in the development of videotex, serious consideration should be given to the desirability of such pluralism in this industry, prior to allowing AT&T to offer these services in competition with others through AT&T's pipeline.

When cable television was new, the Federal Communications Commission decided to keep telephone companies out of cable system ownership because of a concern that telephone companies would stifle competition and dominate the industry. We now have 15 or 20 diverse national program services, such as Cable News Network, ESPN (an all-sports network), and the Christian Broadcast Network, and many regional and local program services as well. It is worth questioning whether these services would have proliferated if the telephone companies owned cable television systems and simply limited cable television to a broadcast television retransmission service for improving reception, or decided to expand channel capacities only when they desired.

There is one more striking example of the potential effect telephone company ownership could have on the fledgling videotex industry. Assume a given service -- say sports scores -- costs the telephone company and an independent entrepreneur the same to produce. In a competitive environment, the telephone company could offer the service at cost and still make a profit on the message units users would incur in accessing the service. While the telephone company could afford to maintain this status as long as necessary, an independent entrepreneur obviously could not compete very long offering its service at cost, or offering the service at a higher price.

In conclusion: It should be our national policy to create a competitive market for new telecommunications services, both informational and transactional, general and specialized. There is a fear among new and potential service and information providers that if AT&T enters this market there will not be a favorable environment (either financially or technically) for the introduction of these services.

Thank you.

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PREPARED STATEMENT OF WILLIAM P. KOCH

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

THANK YOU FOR INVITING ME TO TESTIFY TODAY. I AM WILLIAM P. KOCH, PRESIDENT OF CERTIFIED ALARM AND SIGNAL COMPANY, TOLEDO, OHIO, AND CHAIRMAN OF THE ALARM INDUSTRY TELECOMMUNICATIONS COMMITTEE (AITC).

AITC WAS FORMED TWO YEARS AGO TO BRING THE TELECOMMUNICATIONS DEREGULATION CONCERNS OF THE ALARM INDUSTRY TO THE ATTENTION OF CONGRESS AND THE FEDERAL COMMUNICATIONS COMMISSION. AITC IS COMPOSED OF REPRESENTATIVES FROM THE ALARM INDUSTRY TRADE ASSOCIATIONS (NATIONAL BURGLAR AND FIRE ALARM ASSOCIATION, CENTRAL STATION ELECTRICAL PROTECTION ASSOCIATION, AND THE SECURITY EQUIPMENT INDUSTRY ASSOCIATION), AND COMPANIES PROVIDING SECURITY SERVICES. AITC REPRESENTS A POSITION SUPPORTED BY MORE THAN 8000 COMPANIES ENGAGED IN VARIOUS ASPECTS OF THE ALARM BUSINESS.

WE SUPPORT CONGRESSIONAL EFFORTS TO INCREASE COMPETITION IN TELECOMMUNICATIONS. WE ARE A HIGHLY COMPETITIVE INDUSTRY NOW, AND WE BELIEVE THAT SUCH COMPETITION BENEFITS THE CONSUMER WITH TECHNOLOGICAL INNOVATION AND LOWER PRICES. HOWEVER, WE ARE OPPOSED TO OVERLY BROAD, INDISCRIMINATE DEREGULATION OF AT&T -- DEREGULATION WITHOUT REGARD TO THE PARTICULARITIES OF DISTINGUISHABLE SERVICES AND MARKETS -- SINCE SUCH DEREGULATION WILL NOT ENHANCE COMPETITION: RATHER, IT WILL STIFLE IT.

THE ALARM INDUSTRY'S SPECIFIC CONCERNS WITH REGARD TO TELECOMMUNICATIONS DEREGULATION ARE TWO-FOLD:

(1) THAT THE FCC AND STATE REGULATORY AUTHORITIES CONTINUE TO HAVE JURISDICTION OVER COMMON CARRIER FACILITIES FOR WHICH THERE IS NO REASONABLY AVAILABLE ALTERNATIVE, SO THAT USERS, SUCH AS

THE ALARM INDUSTRY, WILL HAVE THE AVAILABILITY OF A FORUM TO ARGUE AGAINST DISCONTINUANCE OF SERVICE OR UNREASONABLE INCREASES IN RATES; AND

(2) THAT CONGRESSIONAL RESTRUCTURING OF THE BELL SYSTEM NOT GIVE AT&T ANTICOMPETITIVE POWER TO WIPE OUT THE PRESENT ALARM SERVICE INDUSTRY THROUGH AN OVERLY BROAD LEGISLATIVE WAIVER OF THE 1956 CONSENT DECREE.

THESE TWO ALARM INDUSTRY CONCERNS -- CONTINUED ACCESS AT REASONABLE RATES AND UNFAIR COMPETITION FROM AT&T -- ARE A RESULT OF THE UNIQUE SITUATION OF THE ALARM INDUSTRY VIS A VIS THE TELEPHONE COMPANIES.

THE ALARM INDUSTRY HAS A SYMBIOTIC RELATIONSHIP WITH AT&T AND THE OTHER TELEPHONE COMPANIES. UNLIKE ANY OTHER BUSINESS, IT IS -- AND WILL CONTINUE TO BE -- TOTALLY DEPENDENT UPON TELEPHONE COMPANY PROVIDED PRIVATE LEASED LINES FOR THE PROVISION OF ITS SERVICE. THE HIGHEST QUALITY OF SECURITY -- THAT NEEDED BY BANKS, JEWELERS AND DEFENSE ESTABLISHMENTS -- REQUIRES CONSTANT MONITORING OF PREMISES AND CONSTANT SUPERVISION OF THE STATUS OF THE TRANSMISSION LINK BETWEEN THE PROTECTED PREMISES AND THE CENTRAL MONITORING STATION. IN ORDER TO PROVIDE SUCH A SERVICE, AN ALARM COMPANY MUST LEASE PRIVATE METALLIC LINES FROM THE LOCAL TELEPHONE COMPANY. THROUGH THESE LINES THE ALARM COMPANY SENDS AN ELECTRICAL CURRENT WHICH IT CONSTANTLY MONITORS. IF THERE IS EVER ANY CHANGE IN THE STATUS OF THIS CURRENT THE COMPANY IS WARNED THAT SOMETHING MAY BE AMISS. ONLY A DIRECT CURRENT ELECTRICAL LINK, BECAUSE OF ITS CONSTANT, NON-FLUCTUATING NATURE, IS CAPABLE OF BEING SO SUPERVISED. OTHER FORMS OF TRANSMISSION -- SUCH AS VOICE-GRADE TELEPHONE LINES, RADIO SIGNALS, ETC. -- ARE EITHER NOT CONSTANT, OR ARE JAMMABLE. FOR EXAMPLE, IF A BURGLAR WERE TO CUT AN ORDINARY TELEPHONE LINE BEFORE BREAKING INTO A BUSINESS NO-ONE WOULD KNOW OF THE

BREAK IN THE COMMUNICATIONS LINK UNTIL AN ATTEMPT WERE MADE TO PLACE A CALL. THEN, OF COURSE, IT WOULD BE TOO LATE. ON THE OTHER HAND, IF AN ELECTRICAL LINK WERE CUT, THE CENTRAL MONITORING STATION WOULD BE IMMEDIATELY ALERTED.

TECHNOLOGY HAS LED TO THE DEVELOPMENT OF MYRIAD FORMS OF SMOKE, GAS AND INTRUSION DETECTION DEVICES (SUCH AS PHOTOELECTRIC AND INFRARED SENSING, SOUND DETECTION, ETC.), BUT THE ONLY FORM OF NON-COMPROMISABLE TRANSMISSION REMAINS THE ELECTRICAL LINK VIA PRIVATE LEASED LINES FROM THE TELEPHONE COMPANIES. THESE LINES ARE NOT AVAILABLE FROM ALTERNATIVE SUPPLIERS NOR CAN ALARM COMPANIES BUILD THEIR OWN LINES BECAUSE, UNLIKE THE CABLE TELEVISION INDUSTRY, ALARM COMPANIES DO NOT HAVE THE ABILITY TO SPREAD AND RECOUP INVESTMENT COSTS THROUGH A UTILITY-TYPE STRUCTURE. THUS THE ALARM INDUSTRY IS SINGULAR IN ITS DEPENDENCE UPON TELEPHONE COMPANY PROVIDED FACILITIES. DATA PROCESSORS, COMPUTER COMPANIES, CABLE TELEVISION COMPANIES AND OTHERS HAVE SATELLITE AND TERRESTRIAL TRANSMISSION ALTERNATIVES; ALARM COMPANIES DO NOT.

IT IS INTERESTING TO NOTE THAT THE ALARM INDUSTRY HAS NOT ALWAYS BEEN DEPENDENT UPON TELEPHONE COMPANY LEASED LINES. THE ALARM INDUSTRY PREDATES THE TELEPHONE INDUSTRY, AND AT ONE TIME IT WAS ALARM COMPANIES WHICH OWNED THE WIRE LINES AND LEASED THEM TO THE TELEPHONE COMPANIES. IN FACT, AN ALARM COMPANY CENTRAL STATION SERVED AS THE FIRST TELEPHONE EXCHANGE! DEPENDENCE RESULTED WHEN THE TELEPHONE COMPANIES BECAME GOVERNMENT-SANCTIONED MONOPOLY PROVIDERS OF COMMON CARRIER SERVICES AND AGREED TO OPERATE AS REGULATED ENTITIES.

AS YOU CAN SEE, IF LEGISLATION WERE ENACTED WHICH DID NOT PROVIDE FOR CONTINUED REGULATION OF METALLIC PRIVATE LINES, OUR INDUSTRY COULD BE KILLED BY ARBITRARY TELEPHONE COMPANY DECISIONS TO DISCONTINUE THE PROVISION OF SUCH FACILITIES, OR BY UNREASONABLE INCREASES IN PRIVATE LINE RATES.

SIMILARLY, CONGRESSIONAL CONSENT TO AN UNREGULATED ENTRY BY AT&T INTO THE ALARM BUSINESS COULD WIPE OUT THE PRESENT INDUSTRY WHICH IS PRIMARILY MADE UP OF COMPARABLY SMALL COMPANIES. BECAUSE OF THE INTIMATE WORKING RELATIONSHIP THE ALARM INDUSTRY HAS ALWAYS HAD WITH THE TELEPHONE COMPANIES IN THE LINKING OF PROTECTED PREMISES TO THE CENTRAL STATION, AT&T AND THE OTHER TELEPHONE COMPANIES KNOW OUR OPERATIONS INSIDE AND OUT -- EVEN TO THE POINT OF KNOWING OUR TRADE SECRETS AND THE IDENTITIES OF OUR CUSTOMERS! SINCE THE ALARM INDUSTRY WILL CONTINUE TO BE TOTALLY DEPENDENT UPON TELEPHONE COMPANY PROVIDED FACILITIES, IT IS ONLY PROPER THAT THE TELEPHONE COMPANIES BE PRECLUDED FROM THE FAVORABLE POSITION OF OFFERING BOTH COMMON CARRIER AND CUSTOMER SERVICE. SUCH INTEGRATION WOULD BE CONTRARY TO BOTH ECONOMIC THEORY AND THE ANTITRUST LAWS.

THE ALARM INDUSTRY SUGGESTS THAT IF CONGRESS DECIDES IT IS IN THE PUBLIC INTEREST TO ALLOW AT&T TO ENTER UNREGULATED BUSINESSES, THEN LEGISLATION SHOULD BE DRAFTED WHICH PROVIDES FOR A LIMITED WAIVER OF THE 1956 CONSENT DECREE TO ADDRESS SPECIFIC COMPETITIVE CONCERNS. THERE IS NO RATIONAL BASIS FOR AN OVERLY BROAD LEGISLATIVE WAIVER THAT ENCOMPASSES ALARM SERVICES WHEN THE ALARM INDUSTRY POSES NO COMPETITIVE THREAT TO AT&T, IS ERODING NO AT&T MARKET, AND IS A DEFINABLE, SEGREGABLE INDUSTRY. AS WAS DONE IN LAST YEAR'S HOUSE OF REPRESENTATIVES DOMESTIC COMMON CARRIER BILL[1] (AND WAS APPROVED BY THAT CHAMBER'S COMMUNICATIONS SUBCOMMITTEE AND FULL COMMERCE COMMITTEE), ANY DEREGULATORY MEASURES SHOULD PRECLUDE AT&T FROM PROVIDING ALARM SERVICES IN ITS SERVICE AREAS. A SIMILAR CONSENT DECREE WAIVER EXEMPTION PRESENTLY EXISTS IN LEGISLATION NOW BEING CONSIDERED BY THE SENATE COMMERCE COMMITTEE FOR CABLE TELEVISION AND MASS MEDIA SERVICES.[2] IN THE ALTERNATIVE,

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1/ H.R. 6121, Section 218(a)(2)(A)(ii)(I), 96th Cong., 2d Sess. (1980).

2/ S. 898, The Telecommunications Competition and Deregulation Act of 1981, Section 229(b)(1)(A).

THE ALARM INDUSTRY SUGGESTS THAT ANY LEGISLATIVE CONSENT DECREE WAIVER LOOK TO THE EXPERTISE OF THE FEDERAL COMMUNICATIONS COMMISSION, AND GIVE THE COMMISSION AUTHORITY TO APPLY THE WAIVER ON A SERVICE-BY-SERVICE/MARKET-BY-MARKET BASIS SHOULD IT DETERMINE THAT COMPETITION FROM AT&T WOULD BE IN THE PUBLIC INTEREST.

MR. CHAIRMAN, I WOULD BE HAPPY TO ANSWER ANY QUESTIONS YOU OR THE MEMBERS OF THIS COMMITTEE MAY HAVE. AGAIN, THANK YOU FOR THE OPPORTUNITY TO TESTIFY TODAY.

INTRODUCTION OF WITNESSES

Mr. CHUMBRIS. Our next panel will be composed of Edwin Spievack, North American Telephone Association, Washington, D.C., and Mr. William Forster, vice president of ITT in New York.

Mr. Spievack, would you proceed, please?

STATEMENT OF EDWIN SPIEVACK, GENERAL COUNSEL, NORTH AMERICAN TELEPHONE ASSOCIATION, WASHINGTON, D.C.

Mr. SPIEVACK. Thank you, Mr. Chairman, and members of the staff of the Senate Judiciary Committee.

My name is Edwin Spievack. I am a partner in the law firm of Cohn & Marks, and I am also general counsel to the North American Telephone Association.

I want to thank the committee for this opportunity to address you today and to give you some idea of the nature of the industry I represent.

Our industry was created by the FCC in 1968. The founder of the North American Telephone Association, Mr. Tom Carter, was the creator of the Carterfone device that led to the famous FCC *Carterfone* decision in 1968 and, in a sense, opened the door to the competitive environment we know today.

The North American Telephone Association is made up of manufacturers and, for the most part, small vendors who install, sell, lease, and maintain voice terminal telephone equipment supplied to businesses throughout the United States.

To some extent, some of our members are engaged in the manufacture and distribution of stand alone residential telephone sets, but those, for the most part, are sold in retail stores and are installed by the customer or by the phone company.

For the most part, the communications systems and equipment sold by the members of the North American Telephone Association are distributed in a business environment and involve complex types of voice communications.

The voice market, if you will, got started in 1969—about a year after the FCC's *Carterfone* decision. I think the first year's sales in that industry amounted to about $25 million and have grown in 1980 to just under $1 billion.

In that period of 11 years, the interconnect industry, as this industry is known, has gained about 9 percent of the business telephone equipment market, defined in terms of telephone stations.

The Bell System, for example, serves about 47,790,000 business telephone stations. The independent telephone industry serves another 12 million business telephone stations. The interconnect industry, to the extent we have information on it, serves approximately 4 million telephone instruments.

We estimate that with competition, we might be successful by 1990 in achieving as much as 20 percent of the market under current conditions. With the new Bell System migration strategy and the strategy being employed by independent telephone companies to reduce the level of competitive equipment sales, we think that growth may fairly well be stopped by sometime around 1983 or 1984.

At the present time, A.T. & T.'s migration strategy, which we hope to further discuss with this committee, is proving successful. We believe it will continue to be successful so that by the time of deregulation, if it comes, telephone companies in the United States, including A.T. & T., will control over 80 percent of the installed base for business telephone systems in the United States. The annual rate of growth in competitive equipment industries will be cut from the present level, averaging about 20 to 25 percent, to approximately 8 to 9 percent.

In describing the nature of these industries to you, without prolonging the presentation, I would like to make available to the committee a copy of a joint statement which was prepared for submission in May to the House Subcommittee on Telecommunications. It was prepared by the North American Telephone Association, the Independent Data Communications Manufacturing Association, and the Computer Communications Industries Association.

I think the committee will find it instructive in graphically explaining how these various industries are structured and their relationship to A.T. & T.

With your approval, Mr. Chairman, I would like to ask that this statement be submitted for the record and included in the publication of these hearings.

Mr. CHUMBRIS. Without objection, it will be inserted in the record at the completion of your oral presentation.

Mr. SPIEVACK. Generally, I would like to point out that if we were looking in this legislative debate to find the extent to which competition in telecommunications is a factor in the formulation of policy, it would be hard to find.

If we were looking for something we might describe as telecommunications policy, it would be hard to find.

When we look at the development of legislative proposals which have come before this Congress since 1976, what we do find is a fulsome effort not to restructure the Bell System but to leave monopoly power in possession of the markets in which it is now functioning and to simply deregulate it in the future.

In current legislative proposals, pending before the House and Senate over the last 2 years, what we find is an effort to leave the Bell System virtually intact and virtually without any regulatory supervision, in a position to do anything it wants, working off a subsidized regulated base, to control the future of competition in the United States.

What we have is a new development, simply reversing past history. If you look back to the 1934 Communications Act what you see was an effort by Congress to structure a system for the delivery of communications services to the American consumer in a reasonable, nondiscriminatory way to make available, at least possible cost, maximum communications services to all the citizens in this Nation.

In that 47-year period, though the system has worked relatively well, because of recent competitive decisions at the FCC, we now find a changed situation. Because of the bias favoring deregulation, the effort now being made to open new markets to A.T. & T., to free A.T. & T. from the 1956 consent decree to permit its entry into new services, whether it is mass media information, or burglar alarm systems, or private line services or something called enhanced services. A.T. & T. will be free to enter these new markets, contrary to the commitment it undertook in 1956 and contrary to its commitment to remain subservient to regulation.

With that, nothing is being done in legislative formulations we have seen to date to attempt to eliminate the power of a regulated monopoly to cross-subsidize its competitive services off a regulated rate base.

In addition, we are seeing in legislation an effort to cosmetically attempt the appearance of restructuring the communications industry in ways that will preclude the Federal judiciary from restructuring A.T. & T. or any part of the regulated carrier industry, insofar as Federal Government antitrust litigation is concerned. This cosmetic new structure proposed for A.T. & T. will constitute a declaration of congressional policy, inconsistent with a possible divestiture order that might be mandated by a Federal court.

We are also seeing, I believe, a new development in which, for the first time, a major business, with the support of a major industry, is attempting to use the processes of this Congress to restructure and modify, if not totally repeal, a judicially formulated consent decree.

There is great concern about this development. Once such a precedent is established for American industry, any company entering into a consent decree with the Government can, if it does not like it afterwards, merely turn to Congress in order to attempt to subvert the agreement which it undertook to make with all the citizens of this country.

I think those are the issues we see in a broad brush, in terms of so-called new telecommunications policy.

So far in the debate, we have seen nothing concerning the requirements of the competitive market. We have seen nothing concerning what requirements may be necessary for competition to survive against companies that remain partially regulated and partially deregulated, with their potential to cross-subsidize through vertical integration, or to cross-subsidize through horizontal integration with a regulated rate base left untouched.

I think those are issues which most prominently come before this committee.

In prepared testimony which I have already submitted to the committee, I have attempted to describe for you the vertically integrated structure of the Bell System and how it works to produce cross-subsidies through the A.T. & T. general departments, through Bell Labs, through Western Electric, and through the 23 operating companies surrounded by, and encompassed by, the A.T. & T. license contract agreement.

Through that structure, substantial parts of the cost of Western Electric, in terminal equipment, are shifted from the manufacturing entity and merely transferred to the rate base financially supported by all consumers. Therefore, Western Electric is able to bring its equipment to the market without the burden of hundreds of millions of dollars in research and development costs and without the burden of hundreds of millions of dollars in marketing and distribution costs, including advertising, and without the burden of substantially all of the specific product costs that go into the manufacture and distribution of its terminal equipment products.

In that respect, all competitive industries have a great deal to be concerned about.

I hope this committee will read that story of vertical integration and of how Bell Labs and A.T. & T. develop the Western Electric price bogey, a fascinating story in itself it describes the process whereby A.T. & T. surveys all the prices of competitive manufacturers and suppliers in the United States and tells Western Electric the price at which it has to bring a piece of equipment to the market in order to compete. Then the system functions to assure that A.T. & T. will be able to bring the equipment to the market at the price bogey set by A.T. & T. All the costs above the price bogey are simply shifted to general consumers of regulated telecommunications services.

We submit that a competitive environment will not work under the rock of such a structure. We submit that the antitrust laws, by themselves, will be insufficient to protect a competitive environment. We submit that if this Congress is really interested in the control of monopoly and in the future growth of competition, as this committee most particularly has indicated over its past history, then much more is required in developing a telecommunications policy; one that attempts to limit monopoly power so that competition can thrive and prosper in the future.

Thank you very much.

Mr. CHUMBRIS. Thank you very much.

Before starting to questions, back in 1973 and 1974, this Judiciary Committee's Subcommittee on Antitrust and Monopoly held quite a few days of hearings on A.T. & T. and IBM.

Just for the record, this committee is aware of the mechanics of both of those two large industries.

Mr. SPIEVACK. Yes. I remember that well. I testified, I believe, in 1974. I do not think I testified at the 1975 hearings.

Mr. CHUMBRIS. Ms. Tiffany?

Ms. TIFFANY. Mr. Spievack, would you briefly explain what you mean by migration strategy?

Mr. SPIEVACK. The technical name is "installed base migration strategy." It was developed by A.T. & T. and introduced to the Bell operating telephone companies in, I believe, September of 1979.

A.T. & T. was particularly concerned about the fact that it had fallen behind in the introduction of new technology to its customers; that its installed base of its telephone equipment was antiquated.

A.T. & T. recognized its vulnerability to competition in the fact that nearly 80 percent, or more, of its installed base of terminal equipment offered through the Bell System, was over 14 to 15 years old and was technologically obsolete. In addition, most of this equipment had not been amortized on the books of the Bell operating telephone companies. Approximately $8 billion to $9 billion in investment, or more, remained to be recovered, based on the way in which Bell accounts.

Migration was a simple device. It is still in the process of being implemented. All old Bell equipment is raised in price, anywhere from a low of 70 percent to a high of about 140 percent, to force customers to discontinue its use and to push them into more modern equipment the Bell System is now offering at lower cost.

Simply by raising the price of old equipment, Bell is artificially stimulating demand to force customers into newer equipment at lower cost, even though many of those customers would not otherwise choose to change.

In most State jurisdictions throughout the country, the migration strategy is proving successful. In some of the jurisdictions, State commissions are resisting it, as are consumers. In those States, it is not quite as successful. In such jurisdictions, Bell is trying to achieve migration through a very substantial increase in its marketing forces to try to convince customers to move into its newer flagship products.

It is this kind of thing only a monopolist with a monopoly base can do. Only a monopolist can control enough demand, enough supply, and enough price so that it can arbitrarily decide the rate at which it will force customers into new equipment, and do it at a fast enough pace so that competitors cannot equal or meet such falsely stimulated demand within sufficient time to prevent erosion of the monopoly base.

The objective of migration strategy is to maintain 80 percent of the equipment market, and to reduce the level of growth in competitive industries from about 25 percent to about 8 to 9 percent annually. So far, it appears that strategy is working. So once deregulation comes, either by regulation or legislation, Bell will retain its monopoly base intact and will simply transfer it to its new so-called separate subsidiary.

Mr. CHUMBRIS. Mr. Forster, you may proceed with your statement.

STATEMENT OF WILLIAM H. FORSTER, VICE PRESIDENT AND PRODUCT GROUP MANAGER, TELECOMMUNICATIONS AND ELECTRONICS, INTERNATIONAL TELEPHONE & TELEGRAPH CORP., NEW YORK, N.Y.

Mr. FORSTER. Thank you.

I am William Forster, vice president of ITT. I am product group manager for telecommunications and electronics. This, of course, is for our business sector worldwide.

I have been with ITT for 15 years. Until 1976, I was the technical director of ITT in Europe, so I am very familiar with products and markets and also with the way that the 15 telecommunications manufacturing companies in the 15 different countries of Europe work with their telephone companies—the PTT's.

For the last 5 years, I have been back in New York, as product group manager.

I would like to summarize my prepared remarks, which I assume will be in the record.

Mr. CHUMBRIS. Your entire statement will be made a part of the record at the completion of your oral presentation.

Mr. FORSTER. Thank you.

In my 5 minutes, I would like to make five points.

First, the Bell System market—the operating companies and the Long Lines—are about 85 percent of the U.S. telecommunications equipment market. Therefore, you cannot talk about issues of monopolization and competition in the telecommunications equipment market in the United States without facing this fact. Hence, that is where one must start.

Back in 1977, of course, the FCC found that the Bell System was biased toward buying from Western. I will not go into the inherent advantages which Western has there in the written text.

Then in 1968, of course, as Mr. Spievack has said, the *Carterfone* decision opened up the interconnect market, which he has described.

I raise this point here to demonstrate that when you present a vital, dynamic industry—the electronics industry in the United States—when you present that general electronics industry with an opportunity of a clearly open market, to go out and sell your PABX's and your office switchboards to the end users, the businesses directly, they really responded.

They started from a cold start in 1969. By 1974, they had developed products which were even competitive on a world scale. That is, they could be exported and a byproduct that is good for the society.

Bell Laboratories went to work and developed an electronic PABX also, which it took the *Carterfone* decision, perhaps, to encourage.

By 1980, this industry was winning about 50 percent of the competitions with the Bell operating companies. That does not mean they had 50 percent of the installed PABX's.

I am glad Mr. Spievack preceded me, because he explained that 80 or 90 percent installed base issue.

The point is that when it came to competition with a business user/customer, the industry outside of the Bell System was winning about 50 percent, which shows what can be done when industry managers perceive a market to be open.

Fourth, the Bell System each year provides a number of figures to the FCC which tell what the purchases of the Bell System have been for telecommunications equipment from the so-called general trade which is us, the outside suppliers or vendors.

Their number for 1980—and this is very crucial—is that 37 percent of the telecommunications equipment for the construction program of the Bell System operating companies comes from the general trade.

My point is that that number is seriously misleading, and I will explain why. Of course, it is in more detail in the text.

Specifically, the operating companies buy about 22 percent of their equipment from the general trade. That is telecommunications equipment as defined by the Bell System.

That number, incidentally, has been flat. It was 21 percent in 1978, 22 percent in 1979, and 22 percent in 1980. Therefore, nothing is changing macroscopically in the Bell System procurement policies, in spite of all of the discussion which has gone on and the position of the FCC, with which we agree.

Twenty-two percent is a reasonable fraction too, but now let us take it one notch lower. From here on, the Bell System does not publish the breakdown of the procurements into product families. If you are running a business, you have to segment your market. It is the product family that counts.

If you break it down and look at switching, central offices, transmission equipment, microwave, coaxial cable, multiplex, and things like that, and cable—the key products in the network—you find that the general trade share is not 22 percent; it is 10 percent.

As far as we can tell, that has not changed either for the last 3 years.

What does the general trade sell if they do not sell this. The answer is basically that they sell highly specialized niche products. These are products where a company has a special answer to a problem or a patented product or where the market is sufficiently small so that it is not economic for Western Electric to compete and have its own development.

Niche products are good business, because quite often the general trade supplier is the only supplier. That means there is no competition at that level, and really there should be.

What we find when we add this all up is that a general trade supplier cannot build a major telecommunications equipment business on niche products.

Very important from the point of view of the country, he also cannot compete for major export contracts, because you cannot compete in export against Nippon Electric or Thompson CSF in France without having strong switching and transmission products.

Therefore, in conclusion, I think we have to say that the experience of the general trade of the electronics industry in the United States, in selling the key network products to the Bell operating companies and Long Lines in competition with Western Electric, the conclusion has to be that this market is essentially closed to the general trade.

Regardless of anything that the Bell System says, I think that this is true and is the perception of the people who run the general trade companies. That perception is terribly important.

Contrast that with this. If it were practical to structure the industry so that there could be a market which was open in fact, like the PABX market is or has been, if that were true, you could expect the same kind of dynamic performance from the general trade that was brought out when the *Carterfone* decision was made, and that was opened up.

Thank you.

Mr. **Chumbris**. Thank you, sir.

Ms. Tiffany?

Ms. **Tiffany**. Mr. Forster, where do you primarily market the equipment that ITT produces?

Mr. **Forster**. In the United States. The telecommunications equipment is marketed, a very high percentage, to the independent telephone companies—the over 1,500 independent. They are independent independents, as we call them, which do not have their own manufacturing facilities. That really means not Bell and not General Telephone.

Ms. **Tiffany**. Do you export any of the equipment that you produce?

Mr. **Forster**. We currently export about 15 percent of our equipment.

Mr. **Chumbris**. You said a great percentage. Do you have a figure for that?

Mr. **Forster**. Off the top of my head, I would say it is 90 percent.

Ms. **Tiffany**. Do you know whether A.T. & T. exports any of the equipment that it manufactures?

Mr. **Forster**. Yes; they do. They are beginning to. It is a very small percentage, but they are beginning to.

Ms. **Tiffany**. Thank you.

Mr. **Chumbris**. Thank you very much gentlemen.

At this point, we will insert the statement of Mr. Spievack and Mr. Forster.

[The prepared statement of Messrs. Spievack and Forster follows:]

PREPARED STATEMENT OF EDWIN SPIEVACK

My name is Edwin Spievack. I am an attorney with the Washington law firm of Cohn and Marks, and am appearing on behalf of the North American Telephone Association (NATA).

Before getting into the substance of my presentation, first allow me to describe the composition and role of NATA, which pioneered competition in the telecommunications industry.

NATA is a nationwide industry association of more than 300 companies which manufacture, distribute and supply non-AT&T business telephone equipment throughout the U.S. The association was formed nine years ago to help companies take advantage of the FCC's landmark 1968 Carterfone decision, which loosened Bell's stranglehold on telecommunications and opened a new era for free enterprise. The equipment provided by NATA companies, 80% of them small businesses, ranges from the basic single-line telephone instrument and the electronic key system, to ultra-sophisticated thousand-line PBXs. PBXs (or Private Branch Exchanges) are self-contained, computerized switchboards that use state-of-the art technology to create "intelligent" phone systems.

The application of micro-electronics equips a telephone with "intelligence", i.e., the power to perform numerous programmed functions usually associated with small computers. Programming a telephone to manipulate office temperature controls (and save energy), or to control an electronic alarm system (and insure building security) are just two ways in which these innovative manufacturers and suppliers of competitive telecommunications equipment have redefined the parameters of telephone applications and brought new levels of effectiveness and efficiency to end users of every kind.

Ten years ago, there were only about a dozen NATA members with combined annual sales of about a half-million dollars. Today, NATA members sell over $1 billion worth of equipment annually. The competitors' share of the business telephone equipment market has climbed from less than 1 percent in 1970 to about 12 percent today. Experts predict even greater gains during the 1980's.

The competitive communications equipment industry is presently growing at an annual rate of 20 percent. And it is contributing substantially to a favorable balance of payments. In 1979 about $250 million in terminal telephone equipment was imported, much of which was purchased by AT&T. During the same year, more than $380 million in telephone equipment was exported from the U.S., the overwhelming portion of which was shipped by non-Bell suppliers.

Though our industry has experienced dramatic growth in the past several years, it is important to note at the outset that the telephone communications equipment industry is still totally dominated by AT&T and independent telephone companies. In its own service areas AT&T still controls 91% of the installed business telephone instrument base. Independent telephone companies such as GT&E, United, Continental, and others control 96% of this product market within their operating territories.

The ability of my industry to reach even the modest levels of competition that now exist in the equipment marketplace came at considerable cost because of the anti-competitive policies of the dominant monopolist, AT&T. Bell fought us every inch of the way, and hundreds of companies folded, unable to scale the barriers erected by the monopolist to retard the introduction of competition. Discriminatory interconnections, customer intimidation, legal battles in 44 states and before the FCC, pricing policies that hide and reallocate costs--these are just some of the tactics which the world's largest corporation used and continues to use to insure that its century-old "natural monopoly" remains intact.

If it were not for the courageous and far-sighted rulings by the FCC, some state regulatory commissions and the courts over the past decade, my industry would not exist. AT&T would have swept away the fledgling competition and with it the benefits which have flowed to the American consumer from the use of innovative and cost-effective new technologies. As the eminent philosopher Montaigne once noted: "The easy gentle and sloping path...is not the path of true virtue. It demands a tough and thorny road."

I wish I could report to you that all the battles have been won, that all the barriers have been torn down, that full and fair competition exists in the telephone equipment industry today. It doesn't. The victories did not come easily and AT&T's army of almost 1000 in-house lawyers continues to stalk the nation's regulatory agencies and courts, attempting wherever possible to reverse the hard-won victories. In the marketplace, entrepreneurial members of my industry continue to out-innovate and out-hustle the lumbering giant. Gross revenues are at an all-time high, but profits are marginal, at best. And Bell continues to erect monopolistic pricing and service barriers that enhance its market position at the expense of competition.

Now, for the past six years the competitions' victories before the courts and regulatory commissions have been threatened by Congress, operating under the paradoxical notion that the development of new national telecommunications policy can be accomplished by eliminating competition in the name of competition.

Since 1976, Congress has attempted to grapple with the complex political, economic, sociological and technological issues involved in creating a new telecommunications policy. It has held 100 days of hearings, called more than 1000 witnesses, and spent millions of taxpayer dollars in the quest. Despite the effort, it has utterly failed to come to grips with the central questions posed by the issues: the nature of the government-sanctioned telephone monopoly; whether such a regulated monopoly should be allowed to expand into unregulated, competitive markets; and, if so, under what circumstances and with what pro-competitive safeguards.

What has emerged are two inescapable stumbling blocks to even the most modest legislative restructuring of the telecommunications industry: first, the widely held perception that no new telecommunications policy can ever be enacted without the assent of the dominant monopolist, AT&T; and, second, the misguided notion that telecommunications deregulation is akin to previous deregulation efforts in the airline, trucking, railroad and natural gas industries.

Sen. Hollings dispelled this second notion two years ago when he accurately remarked: "Telecommunications is not like trucking or airlines where no carrier has ever had an overwhelmingly dominant position, let alone a sanctioned monopoly....[AT&T's] plant not only can be used to provide both monopoly and competitive services--but access to it is essential for almost any other carrier [or manufacturer] wishing to provide these services [or products]....The situation is rather like having one airline which owned all the big city airports or one trucking company which owned the Interstate Highway System."

As for the former perception, if the U.S. Congress wants to give AT&T veto power over national policy-making, it should say so at the threshold and we can all pack our briefcases and go home.

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I am especially pleased to appear today before members of the Senate Judiciary Committee, because you have both the expertise on questions of monopoly and the sensitivity to understand the societal and economic ramifications of anti-competitive practices by such monopolists.

S. 898, the so-called "Telecommunications Competition and Deregulation Act of 1981," is alleged to be a communications bill. As this Committee so quickly and accurately recognized, it is far more than that. It is inconceivable that a bill, which admittedly overrides a judicial consent decree, and obviously will have a significant impact on the application of antitrust law (most notably as it affects the massive U.S. vs. AT&T antitrust case), can be considered anything but an antitrust bill. The very nature of the telecommunications industry--and the inclusion of AT&T in it--means the bill has major antitrust ramifications.

Previous Senate Judiciary Committees recognized the central role of antitrust laws in the telecommunications industry. They considered the Industrial Reorganization Act of 1974 and the Competition Improvements Act of 1975. AT&T's monopoly position and behavior was a persistent focus of those hearings.

Last year, the House Judiciary Committee recognized the serious antitrust ramifications of H.R. 6121, a bill which sought almost the identical give-aways to AT&T as this year's reincarnation, S. 898. The House Judiciary Committee made a convincing case that H.R. 6121 was at least as much of an antitrust bill as a telecommunications bill, and because of its anti-competitive aspects reported it "adversely" to the House floor. (I would like to include a copy of that House Judiciary Committee report on the record.)

Before commenting directly on S.898 and its flawed, anti-competitive solutions, let me briefly draw a portrait of AT&T, the monopolist.

There are many ways to characterize and quantify a monopoly, but sheer statistics provide the simplest profile. The numbers illustrate both AT&T's dominance in the telecommunications field and Bell's huge influence on the U.S. economy.

--Last year, AT&T reported more than $125 billion in assets, more than the Fortune 500's top 3 industrial corporations combined (Exxon, Mobil, GM);

--Last year, AT&T reported gross revenues of $50 billion and record profits of more than $6 billion;

--AT&T has more than 1 million employees, exceeding the combined size of the Postal Service, Veteran's Administration, Internal Revenue Service, and Commerce Department;

--In terms of GNP, AT&T would be the 20th largest country in the world, or about the size of France; and

--AT&T (and all its affiliated companies) this year will siphon off more than one-fifth ($17 billion) of the net new capital available in the U.S.

Another benchmark with which to measure the power of a monopolist is its behavior in the marketplace--specifically its reaction to competition. Let me draw your attention to AT&T's most recent marketing program--the "migration strategy"--which has been characterized as "the most convincing argument yet that real competition does not exist in the telecommunications equipment industry."

Classic economic theory would have it that a monopoly, faced with competition or even the threat of competition, would lower its prices below marginal cost to undercut the competitors' offerings. Bell, true to form, has employed such cost-cutting tactics for the past decade. However, the migration strategy, launched nationwide 18 months ago, provides a new wrinkle--Bell has decided to raise prices on telephone equipment with the same end in mind, to crush competition.

The strategy was outlined in a front-page article in the Wall Street Journal on April 24, 1981 (a copy of which I submit for the record). Bell is asking state utility commissions across the country to dramatically raise prices (as much as 140%), on old equipment, in order to force customers to buy Bell's newer equipment, which suddenly becomes relatively cheap. Customers, through a Variable Term Pricing Plan (VTPP), are coerced into long-term contracts (4-7 years) on this newer equipment. Bell's aim, as discovered in internal AT&T documents, is to lock up 80% of the PBX equipment market in the next three years. Thus, competition ends as deregulation begins.

Competing manufacturers lose because, although we might pick up some of these new customers in the next three years, AT&T knows we are not yet competitive enough to adequately supply the dramatically increased demand. Customers lose because they are coerced into buying newer equipment, which they frequently don't need. And the American public, the residential rate-payers, lose because they are forced to absorb the estimated $4 billion cost of the older equipment that has been prematurely retired--the losses of which have been dumped into the monopoly rate base.

The migration strategy is only the latest example of Bell's ability to manipulate the market to its own advantage, thus perpetuating its monopoly dominance. The key to understanding Bell's ability to manipulate markets lies in its vertically integrated structure, from which all monopoly blessings flow.

At the top is AT&T, which includes AT&T management and the AT&T General Departments, which among other things undertake and supervise marketing, public relations, management, accounting, legal, regulatory and legislative activities for the entire Bell System. Below there is Long Lines, the long-distance transmission division which manages the nationwide communications grid. There is also Western Electric, the wholly-owned manufacturing subsidiary, which alone had assets of $8 billion and sales of $12 billion last year--enough to rank it 22nd in the Fortune 500, ahead of such industrial giants as Standard Oil of Ohio, Proctor and Gamble, Dow Chemical, Union Carbide, Kodak and Xerox. Next, there is Bell Labs, owned jointly by AT&T and Western Electric. And last, there are the 23 Bell Operating Companies, which are owned either wholly or partially by AT&T. Together, they make up the Bell System, which is far from the "solution" proclaimed by AT&T's nationwide advertising. Instead, this "system" is the primary bottleneck that prevents competitive and innovative services and products from reaching the American public.

The vertically integrated structure easily allows AT&T to price equipment and services below marginal costs, one convincing sign of monopoly power. The primary tools are the License Contract Agreements AT&T has with its 23 operating companies, and the Western Electric accounting system.

Unrefuted evidence drawn from proceedings before state commissions in Massachusetts, New York, California, Colorado, Montana and Kansas (among others) prove that the Bell System is a seive through which subsidies flow. The principal aim is to hide Western Electric's true costs so that Bell's manufacturing subsidiary can meet competition with prices below marginal cost. The AT&T General Departments, Bell Labs and the 23 Bell Operating Companies all subsidize Western Electric by shifting the manufacturer's costs to the monopoly rate base. The bottom line of this sleight-of-hand is that the captive rate-payer, through his monthly phone bill, is financing AT&T's efforts to swat competitive flies.

Even AT&T admits this privately. In a 1969 speech to Bell employees (recently introduced as evidence in the government antitrust trial in Washington), former-AT&T General Counsel Howard Moulton said: "The first law of the economics of competition is that you can always beat your competitor if you are willing and able to underprice him by selling below your relevant costs. The second law is that this is a sure way to go broke unless you can cover your losses with the profits from some other service or product. And the third and most important law is that if you are caught in the act--namely, if you subsidize your competitive service from the profits of monopoly services--you are engaging in anti-competitive conduct which is unlawful and will be appropriately punished." Unfortunately, AT&T is rarely caught at the game. The blatancy is now a matter of record. That it has yet to be reigned in under the law has become a legal as well as economic shame.

The antitrust laws, as important as they are to police monopoly abuses, are not very helpful on a daily basis. Application of the antitrust laws is often too little, too late--after the victim of monopoly abuses has been forced out of business. The real importance of antitrust law comes when its application metes out a structural relief that precludes future monopolistic behavior.

When a NATA manufacturer is ready to sell a new piece of telephone equipment, he must include in its price the cost of research and development, marketing, manufacturing, overhead, tax expenses, financing expenses, etc. He can't hide those costs or shift them to a regulated, monopoly affiliate.

Not so with Western Electric and Bell Labs. The General Departments of AT&T perform elaborate marketing, management, customer service and public relations work for Western Electric. These activities include the coordination and direction of Bell Labs' product R&D, as well as the various tasks for the introduction, promotion, sales and management of Western Electric terminal equipment through the operating companies. They also include the costs for legal and lobbying representation. The General Departments should bill Western for this work. Instead, they bill the 23 Bell Operating Companies, which pass the costs on to the captive rate-payer in the form of monthly phone bills. The General Departments' bill to the operating companies in 1977 was $52 million; conservatively, the cost last year was more than $100 million.

The internal management systems within Western Electric and Bell Labs also are subject to frequent juggling. Although Bell Labs performs extensive R&D for Western Electric, Western picks up the tab only if the research is designated "Specific Design and Development." Costs for "Research and Fundamental Development" and "System Engineering" (in-depth marketing studies and strategies to counter competitors) are passed on to the General Departments, which again send the bill to the operating companies, which again pass the costs on to the captive monopoly ratepayer. It is difficult to discover the specific dollar value of product R&D shifted away from Western; however, the evidence indicates that it amounts to nearly 40% of all Bell Labs' annual R&D expenses.

AT&T management, through Bell Labs, determines what constitutes Specific Design and Development and what is Research and Fundamental Development. The decision is based primarily on what the market will bear. As Moulton told Bell employees: "Shorn of the high-sounding semantics of the economists, this is precisely what our costing and pricing problems now pending before the FCC are all about. We can compete if our rates for our competitive services cover their relevant costs plus a fair profit, so the key issue is: What are our relevant costs and how are they to be determined in any given situation?"

When a NATA manufacturer wants to introduce a new product, the company first must make a marketing study to determine the potential demand and possible price. If it finds that R&D, manufacturing and merchandising will be too costly it will not introduce the product. Western Electric has the luxury of doing it the other way around. It first determines the final price (invariably below the competitors'), then determines how to hide and reallocate costs to justify that price.

AT&T calls this the "price bogey," the price Western Electric must meet in order to compete with the product of independent manufacturers. The allocation of Research and Fundamental Development and marketing costs to the AT&T General Departments is one way to shed Western's costs. Another is an internal Western Electric management system, whereby Western spreads the costs of development, merchandising, general overheads and tax expenses related to a specific product over an entire product line. These two forms of manipulation insure that the targeted product does not exceed the "price bogey."

For instance, the California PUC found that Western shifted the costs of producing a sophisticated business PBX system to a product line that included single-line phones sets used by residential customers. The upshot was that the final PBX prices charged by the Bell operating companies were priced at least 32% below Western's costs.

Thus, Bell's alleged economies of scale and scope are no more than a continuous shuffling of costs away from a marginally competitive entity (Western Electric) to 23 total monopolies (Bell's local operating companies).

There are other anti-competitive problems in such a tightly integrated structure. Consider the most obvious--AT&T's total control of the nation's transmission system, the so-called "network," and its ability to simultaneously (through Western Electric) compete in providing telecommunications products and services that must plug into that network. This is the ultimate corporate conflict-of-interest. The short history of competition is marked by discriminatory interconnection requirements imposed by AT&T on Western Electric competitors (i.e. protective couplers), excessive access charges imposed by AT&T on Long Lines' competitors (i.e. MCI, ITT), and a series of "people problems" inherent in such a vertically integrated structure. Whenever a competitive equipment customer has a problem, he is referred to the marketing department of the phone company. The Bell marketing department must sell Western's products. Sales lost to competition are marked against the Bell salesman's record. Do you expect that salesman to help solve a competitor's problem?

In addition, Bell Labs shares insider information with Western Electric on planned technical changes in the network, thus denying competitors the necessary lead time to modify their equipment. Network ownership allows AT&T's marketing department to obtain a treasure trove of marketing data on the competitors' customers through the FCC's equipment registration program; competitors are not allowed one wit of similar information pertaining to AT&T's huge installed ba[illegible].

The obvious solution to these inherent corporate conflicts-of-interest is the one sought by the Department of Justice in its massive antitrust suit, which seeks to break up AT&T. There is no more reason for AT&T to continue to manufacture telephone equipment that interconnects with the communications grid than there is for the local utilities (i.e. PEPCO, VEPCO) to manufacture light bulbs and toasters that connect with the electric grid. If competition is to have even a prayer of survival, the network must remain totally neutral--open to free and non-discriminatory access by all transmission providers and manufacturers. No carrier, be it AT&T or the more than 1600 independent phone companies--which are often overlooked and have total monopolies in their local service areas--should be allowed to provide both transmission service and the manufacture or distribution of telecommunications equipment.

Bell has several additional monopolistic advantages:

-- AT&T is allowed to use a preferred credit rating to obtain capital for both its monopoly and competitive enterprises. This advantage is not a real economy, of course, in that such capital leveraging simply serves to spread competitive market capital costs over both the protected and open markets in which the parent company operates. Thus, capital costs are raised in protected markets, where there is no competition, and reduced in competitive manufacturing industries, where unsubsidized rivals are present. Most of your constituents are now feeling the pinch on their local phone bills. The fundamental cause of basic telephone rate increases is not some mysterious rise in the cost of your constituent's residential telephones, local service lines or central office switches. Rather, the cause is largely a matter of Bell's new and innovative accounting techniques which permit the reassignment of competitive market depreciation, capital, marketing, and overhead costs to monopoly local utility service markets.

-- AT&T is able to file consolidated tax returns, whereby the Bell system shares with its affiliates its effective Federal tax rate of 9% (earned thanks to its monopoly rate base). Testimony last year before the House Judiciary Committee indicated that AT&T's competitors have an average 46% marginal tax rate.

-- There is also marketing pressure, whereby AT&T intimidates potential customers of competitive equipment and services. Let's say you are a small business which wants to purchase a telephone equipment system from an independent vendor. However, you must still depend on service from the local phone monopoly (C&P, for example) and you must continue to hook into the Bell System's communications grid. As a small businessman, what do you say when the C&P marketing representative pointedly reminds you of your dependence on the Bell System? You'd say what hundreds of potential customers have said--"It's not worth the trouble."

Or, let's say you're the largest computer company in the world and are considering introducing into the U.S. a competitive telephone switching system (Carnation) that has sold extremely well in Europe. But you also have the renewal of hundreds of millions of dollars worth of computer contracts pending with the Bell System. You'd do what IBM is alleged to have done in the Litton vs. AT&T antitrust case now before a jury--you'd withhold domestic marketing of the Carnation System in order to hold on to the substantial computer business you do with the phone company.

These monopolistic practices are all part of the extensive and damaging public record amassed during a long history of antitrust suits (public and private) against AT&T. More than 50 such suits have been filed in the past decade; 25 are still pending and will be irrevocably affected by any congressional action such as S. 898, which favors AT&T.

AT&T is currently the defendant in the largest antitrust suit ever filed by the U.S. Government, the second such antitrust suit filed against them in the past 32 years.

S. 898 would both bless AT&T's past monopoly behavior and invite new anti-competitive practices. Once again, competitors in the telecommunications equipment industry are faced with a legislative proposal whose intent is laudatory, but whose affect will be to destroy the competition it pretends to promote. S. 898 would restructure the telecommunications industry to allow AT&T to compete on an unregulated basis in areas it has been forbidden from entering by the 1956 Consent Decree, a judicial settlement that resolved the Government's previous antitrust case against AT&T.

The centerpiece of S. 898 is a cosmetic restructuring plan that allows AT&T to establish a separate affiliate for the provision of unregulated, competitive telecommunication services (private line, WATS) and products (terminal equipment, data processing equipment and computers). Basic telephone service would remain the province of the parent, which would continue to be regulated indefinitely.

Such a scheme--which creates a hydra-headed monster, half-regulated and half-unregulated--has been discredited ever since its introduction (at AT&T's initiative) a few years ago. William Baxter, the Assistant Attorney General for Antitrust, says the centerpiece of his prosecution of AT&T is the need for the divestiture of AT&T's regulated activities from its unregulated activities. In a press conference on April 9, Mr. Baxter said his goal is "to separate all the regulated components of the enterprise (AT&T) from the unregulated components." Mr. Baxter's predecessor testified before the House Judiciary Committee last year, "The establishment of separate subsidiaries cannot eliminate the incentive of such subsidiaries to discriminate in favor of their affiliates, or the incentive of AT&T to circumvent regulatory contraints on its behavior." In response to a question, the nation's chief antitrust officer said, "I have grave doubts...about the ability of a separate subsidiary to work even in the fashion in which the legislation (H.R. 6121) is designed, namely, to deal with cross-subsidies."

These comments reflect the historic position of the Justice Department, which has consistently maintained that separate subsidiaries or affiliates are thoroughly inadequate to deal with the anti-competitive incentives of a monopoly.

During those same hearings before the House Judiciary Committee last year, the General Accounting Office, the Federal Trade Commission, two past chiefs of the FCC's Common Carrier Bureau, and several academic and public policy officials also testified to the inadequacy of separate subsidiaries as a check on monopoly power. The principal proponent of separate subsidiaries is AT&T management. When powerful economic interests are jeopardized (newspaper publishers and cable TV operators), the separate affiliates are found inadequate to protect the public. S.898 prohibits AT&T from providing cable-TV and mass-media services; in other words, the N.Y. Times and Time Inc.'s HBO cannot cope with Bell's separate affiliates, but a terminal equipment company (with assets of less than $50,000) can!

The separate affiliates outlined in S. 898 are nothing new. Bell has had separate affiliates for years that have been able to cross-subsidize and price predatorily at will--even under regulation. How Congress expects to prevent abuses by the new affiliate in a deregulated environment is beyond comprehension, especially considering the new "Baby Bell" will have $10 billion in assets on the date of its birth.

AT&T will still be able to shed costs through sleights-of-hand, to discriminate in the provision of interconnection rights and access charges, to conduct joint ventures and joint advertising, to use consolidated financing and tax returns, to share common directors, employees and facilities, and to make use of insider information on planned network changes and the competitors' installed base.

In other words, under S. 898 all the current incentives for anti-competitive behavior remain intact. But a significant new incentive is added--the transition period during which AT&T supposedly must shift some of its regulated manufacturing and research activities to its newly unregulated clone.

The eight-year transition called for in the bill is unrealistically long, unless one wants simply to give AT&T statutory license to play monopoly musical chairs. The opportunities are legion for cross-subsidization during the long and chaotic shifting of personnel, assets and equipment. Even the final separation has more loopholes than force, since AT&T can totally circumvent the requirements by establishing a wholesale supply house to sell "subassemblies" and "components", the essential building blocks of all telephone equipment.

Most important to your Committee are two features of the bill which go straight to the heart of the antitrust question--the ongoing U.S. vs. AT&T antitrust case and the 1956 Consent Decree.

It is so obvious that S. 898 would gut the Justice Department's antitrust case that even the bill's chief sponsor, Sen. Robert Packwood, admitted as much in a press conference last November: "Let's settle the case legislatively. I hope we can get that suit behind us." In a recent letter to OMB Director David Stockman, Assistant Attorney General Baxter said that passage of the bill, or even administration endorsement of it, would hinder his prosecution of the case.

The pitfalls of legislative intervention into a presumedly independent prosecutorial process, especially one of this magnitude, were most succinctly expressed by Mr. Baxter in his recent letter to OMB Director Stockman:

> "Although S. 898 contains an antitrust savings clause, section 404, which states that passage of the bill is not to be construed to affect pending antitrust litigation involving AT&T or the availability of structural relief, we believe that S. 898's passage could have an adverse impact on the Department's AT&T litigation. In spite of the differing views among economists and public officials concerning the effectiveness of the fully separated affiliate mechanism, proposed section 201 of the 1934 Act states that the mechanisms established by S. 898 are "appropriate safeguards to prevent anticompetitive practice". We believe such a Congressional declaration contained in legislation dealing comprehensively with the structure and the regulation of the communications industry, although in no way legally controlling, is very likely to influence the trial court's willingness to award the structural relief we believe necessary to establish effective competition in the telecommunications market that we allege AT&T has monopolized. In the face of such a Congressional declaration, particularly if supported by the Administration, a court might be very hesitant to order structural relief when a Congressional-mandated separate subsidiary approach was coming into being. It would be ironic if an opportunity for structural relief that would permit the true deregulation of the telecommunications industry were to be lost, due to enactment of legislation mandating continued regulation of AT&T for the indefinite future."

House Judiciary Committee Chairman Peter Rodino made most of those same observations in a letter last July to Rep. Lionel Van Deerlin, then chairman of the House Communications Subcommittee. (I ask that copies of the Baxter and Rodino letters be included in the record.)

The wholesale restructuring of the AT&T System, cosmetic as that restructuring is, would necessarily preclude Judge Greene from granting the essential pro-competitive remedy--divestiture--even when the Justice

Department wins its case. Virtually every witness before the House Judiciary Committee last year acknowledged that Congressional restructuring of the telecommunications industry before the trial is completed would necessarily have to influence Judge Greene's ultimate decision; those witnesses ranged from AT&T General Counsel Howard Trienens to former Attorney General William Saxbe, who filed the suit against AT&T in 1974.

A critical question before this Committee--and before the Congress--is whether Congress wants to infringe so drastically on a judicial proceeding, especially one of this magnitude?

S. 898 would not only moot the U.S. vs. AT&T antitrust case, it would undoubtedly affect the 25 other pending or ongoing private antitrust suits against Bell. And more importantly, the bill would affect the nation's antitrust laws as they apply to monopoly in the telecommunications industry from this date forward.

If Congress wants to alter the antitrust laws, it should do so by rewriting the Sherman and Clayton Antitrust Acts. Such drastic revamping--however ill-advised--should originate in the respective Judiciary Committees of Congress, which have antitrust jurisdiction.

Secondly, S. 898 admittedly eliminates the 1956 Consent Decree, the settlement that resolved the government's previous antitrust suit against AT&T, filed in 1949. If that Decree is to be modified--the Justice Department and virtually every competitor of AT&T believe it should not be--then such modification should occur in the original court of jurisdiction. Legislation by Congress, or regulations by the FCC that pre-empt the authority vested in the court of jurisdiction, calls into question a major constitutional issue involving the proper separation of powers.

Again, if Congress wants to rewrite antitrust law--specifically if it wants to alter the manner in which consent decrees are negotiated and/or modified--that legislation should originate in the Judiciary Committees. End-runs on antitrust law, initiated by Commerce Committees and hidden in bills that supposedly deal with communications policy, subvert both the Congressional process and the laws of the land.

While I have spoken today primarily about the particular concerns of a single industry--the manufacturers, suppliers and distributors of competitive business telephone equipment--I realize that we are not the only--or even the central--player on the stage. Technologies and market forces exist today that even six years ago, when debate on telecommunications policy began, were just dreams of the future. As the country enters the Information Age, a variety of forces and a multitude of players are converging. It is important for this committee to recognize that a number of the players have either a monopoly or government-sanctioned franchise in their discrete areas: not just AT&T in telephones, but satellite companies, telegraph companies, computer companies and mail-service organizations in their respective markets.

In considering any legislation affecting telecommunications and the marketplace of the Information Age, you will find all these monopoly forces vying for future control. These forces will shift positions as the form and thrust of the various pieces of legislation change--sometimes in the center, at other times on the periphery. Regardless of their position at any given time, the monopoly presence is a fact of life.

It is also a fact of life that legislation that does not take into account and seek to resolve the continued appropriateness of monopoly status will only create new problems, for Congress will have failed to address the old problems first.

More than 200 years ago, Adam Smith observed:

> "Every man, as long as he does not violate the laws of Justice, is left perfectly free to pursue his own interest in his own way, and to bring both his industry and capital into competition with those of any other man or order of men."

My industry believes in the wisdom of that statement and the traditional system of enterprise which has contributed so abundantly to this nation's freedom and strength. But the wisdom of that statement also dictates that justice--whether in Congress or in the courts--will be done to those who violate the law.

PREPARED STATEMENT OF WILLIAM H. FORSTER

Thank you Mr. Chairman,

I am William H. Forster, a Vice President of ITT and Product Group Manager for our Telecommunications & Electronics business sector worldwide. I have been with ITT for 15 years. Until 1976, I was Vice President and Technical Director of ITT Europe with responsibility for supervising the research and product development of our telecommunications companies in 15 countries. I am familiar with the products and markets and with the relationships which exist between suppliers of telecommunications equipment and the PTTs.

Since 1976, I have been headquartered in New York with a worldwide responsibility as Product Group Manager.

In the United States, 80 percent of the 185 million telephones are owned by AT&T, 10 percent by GTE and 10 percent by the more than 1500 so called Independent-Independent telephone companies. In discussing competition in the telecommunications equipment manufacturing industry one is forced to look first at the Bell System Market. In addition to having 80 percent of the local telephone lines, Bell's Long Lines is the major factor in the long distance network so that the total AT&T market represents about 85 percent of the telecommunications equipment business.

The FCC in 1977 found that there is a "...bias in favor of Western products (which) limits not only the autonomy and independence of the BOC but also precludes a fair opportunity for the general trade to serve BOCs equipment needs" and that the "...overall Bell System procurement and make/buy decision processes in which BSPPD participates, inherently favor Western". There has been essentially no change in this situation or in the market share of the general trade suppliers in comparison with Western Electric since that time.

Hence, the universal perception and the decision making thinking of the suppliers of telecommunications equipment is that the market represented by the 23 Bell Operating Companies and Long Lines is essentially closed for product families which are manufactured by Western. This is true, as we have found, even in those instances where ITT developed a product demonstrably cheaper and better than the comparable Western product.

This is not surprising. Western Electric has several inherent advantages:

- First - Western works with the BOCs and Bell Labs to define the requirements and develop a product tailored to their needs. When the development is complete and Western's production has started the specifications are finalized and given to the general trade. If they then wish to compete, they have to adapt their product to the Bell System specs and then go through the process of having it tested for "suitability to the Bell System requirements".

  The net result is that the general trade product is usually not ready for useful production until two to three years after its Western competition is on the market With the decreasing product life which is characteristic of today's electronic products, this means that the general trade product has a market window of, perhaps, four years versus seven for Western. This is such a major competitive disadvantage that it makes it very difficult for a general trade supplier to compete head-to-head with Western.
- Second - The working relationships between the operating companies and Western have been built up over the years and constitute a major barrier to outside vendors. Wester Electric is a full member of the AT&T family and the

normal instincts of the operating company personnel who make the final purchase decisions can be expected to follow the well proven pattern. One would not expect a manager to be fired for deciding to "Buy Western", whereas a service problem resulting from a decision to buy in competition with Western could be considered "poor management judgement".

- Lastly, the "Life Cycle Cost Analysis" performed on products before they are accepted as "suitable for use in the Bell System" includes participation by Western. There are several factors which are difficult to quantify and which can be interpreted in different ways. The result is that even when a supplier concludes that the data shows his product to be more economic the Bell System studies may very well favor Western.

You will recall that in 1968, the FCC's Carterfone decision first authorized the connection of other-than-telephone company provided equipment to the telephone networks. The major products involved were PABX's -- the office switchboards - and multi-button and key telephones. Prior to that time the telecommunications equipment manufacturing companies which were not affiliated with a telephone company had had little domestic market for these products. Within 5 years, by 1974, the U.S. industry had developed products which were demonstrably competitive in the world market -and - as a side benefit - the Bell Laboratories had put on a crash program to develop a competitive electronic PABX. By 1980, in the short space of 11 years the Bell Operating Companies were losing about 50% of the orders for new or replacement PABX to non-Western products, and U.S. manufacturers were exporting products all over the world. Several U.S. designs have now been adapted to European PTT requirements.

I think we can conclude that the managers of the U.S. manufacturing companies perceived the interconnect market to be open. They invested resources in product development and marketing; the results have been outstanding.

Now let's look at the Bell System market for network products - the switching, transmission & cable equipment. BSPPD reports for the last three years show the following:

Bell System Telecom Product Purchases

$ Billions	1978	1979	1980
From Western	5.6	6.5	7.5
From Gen'l Trade			
Direct	.8	1.0	1.2
Thru Western	.7	.8	.8
Sub-Total	1.5	1.8	2.0
% From Gen'l Trade	21%	22%	22%

These numbers show that the general trade supplied the BOCs with $2.0B worth of telecommunications products in 1980 - up from $1.8B in '79 and $1.5B in '78. The general trade share of the BOC and Long Lines telecom equipment purchases remained constant at about 22%.

The BSPPD reports to the FCC reduce the Western sales to BOCs by the electronic components and subsystems which Western purchases to incorporate into its products - $1.4B in '80. They add this to the $2.0B sales of the general trade to the BOCs and conclude that Bell buys 37% of its telecommunications products from outside.

If, however, you look at the general trade sales of the network products - that is, of switching, transmission and cables - their share is about 10%. This analysis is based on detailed market research as this breakdown is not published by BSPPD. As far as we can tell, the 10% share has not changed over the last three years. I suggest that BSPPD's 37% figure is misleading. The 10% number should be the basis for policy considerations.

The conclusion is: The BOC market for network products is not open. The general trade is selling niche products - products for small markets where the outside supplier has a more competitive design than Western or for which Western has decided that the market is not sufficiently large to justify its own product development. Niches are good profitable businesses, but you can't build a major telecommunications equipment business or win significant export contracts without the core switching and transmission products.

Central office switching is about 50% of the market for network products - by far the most important product family. The cost of developing a line of digital switching equipment today is typically from $100M to $300M. The Independent-Independent market today, is about 750,000 lines per year - 11% of Bell. Five U.S. and four foreign companies are competing for this $300M/yr market - clearly not an economically viable situation. Experience suggests that it can be served effectively by companies such as Western, Automatic Electric which is part of the General Telephone System and Northern Telecom which is affiliated with Bell Canada. It cannot be economically supplied by an independent manufacturer unless he also has access to a major affiliated market. ITT, of course, looks forward to penetrating the Bell switching market, but the structural relationships between Western and the BOCs and the industry experience of the last three years suggests that our business strategy may not be realistic. Also, our ability to compete in export markets from our U.S. base is dependent upon having a domestic market which is large enough to cover the cost of product development.

In conclusion, I suggest that the experience of the U.S. telecommunications industry in selling to the Bell System shows that the BOC market for major network and office switchboard products is essentially closed to general trade suppliers. On the other hand, if by structural changes it were possible to create a market which was in fact open, we could expect the same kind of dynamic performance in selling to BOCs that the industry has demonstrated so outstandingly in building its 50% market share in the "interconnect" market.

Thank you Mr. Chairman.

P.S. The paper by William H. Forster entitled: The Bell System As a Market, which was presented before the Electronic Industries Association Symposium on Telecommunications Trends & Directions - Hyannis, Mass., May 27, 1981 is appended.

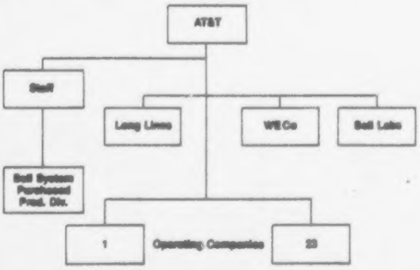
THE BELL SYSTEM AS A MARKET*

By William H. Forster
Vice President and Product Group Manager,
Telecommunications and Electronics
International Telephone and Telegraph Corporation; New York, N.Y.

The EIA has asked me to speak on the Bell System market. I expect Mr. Himsworth invited an ITT speaker because we have been leaders in encouraging the Bell System to further open its market to outside suppliers or, in the nomenclature of the Bell System, to the "general trade." AT&T and ITT have had some well-publicized legal battles that have been resolved — but, on the other hand, the Bell System has been a good and valued customer for many years and we look forward to expanding that relationship. I will do my best to describe the Bell System market — at least as we perceive it — and to show where and in what way a company like ITT participates.

The organization chart of AT&T (Figure 1) shows the key units that buy telecommunications products and systems. The 23 Bell Operating Companies plus Long Lines are the customers, each with its individual personality and tradition — they are 23 different customers. The Bell System Purchased Products Division (BSPPD) is part of the AT&T Staff Department. It serves as an access point and a coordinator for the general trade. It negotiates some umbrella contracts based on qualifying a general-trade product as suitable for Bell System requirements. The BSPPD is not intended to be a bottleneck; rather, it encourages direct sale to the BOCs and Long Lines.

Figure 1 — Bell System Structure.



Before discussing the Bell System's market quantitatively and by product family segments, I would like to propose a qualitative framework to evaluate the probability of success in selling to the Bell System.

Bell procurement policy varies markedly depending upon whether or not Western Electric is a potential supplier. I have chosen four categories:

- **Commodities** include telephone poles, building materials and many other products. They are widely available, but also products that WECo specifically doesn't make. Bell is a good customer for commodities. They write clear specifications, know what they want and they pay fair prices.
- **Niche products** include many varieties of electronic equipment including specialized test instruments and some network and end-user products that are procured in quantities judged to be more appropriate for small companies or divisions of large companies rather than for WECo. Again, Bell is a good customer: They work with their suppliers and demand high performance and excellent reliability. Their planning processes make it practical to build a responsive supplier organization and the Bell stamp of approval is respected and valued around the world. There are several companies represented in this room today that got their start as a supplier of a niche product to the Bell System.
- For **network products** and **customer premise** equipment, WECo is a worthy and increasingly aggressive competitor. WECo people fight for market share just like the rest of us. This area is the center of the legal and regulatory debate.

Globally, the Bell System market is huge (Table 1). The construction budget for 1979 was $8.3 billion for telecommunications products — up 17% from 1978. In addition, it was $7.5 billion for non-telecommunications products such as automobiles, buildings, furniture, etc., and for services. These numbers come from an AT&T report submitted annually to the FCC. The 1980 numbers will be out shortly.

TABLE 1

1979 CONSTRUCTION BUDGET

Dollars in Billions

	1978	1979	% Change
Telecom Products	7.1	8.3	+ 17
Non-Telecom Prod or Servs	6.6	7.5	+ 14
Total	13.7	15.8	+ 15

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*Presented before the Electronic Industries Association Symposium on Telecommunication Trends and Direction, Hyannis, Mass., May 27, 1981.

First, let's examine how the telecommunications products were procured (Table 2): $5.5 billion of the $8.3 billion in telecommunications products were manufactured by WECo. The general trade sold $1.8 billion of finished products in 1979, up from $1.5 billion in 1978. Of the $1.8 billion in 1979, $1 billion was procured directly by the BOCs and $800 million came in through WECo acting as purchasing agent. In addition, WECo purchased another $1 billion worth of components. In the WECo definition, this category includes electronic subsystems from minicomputers to ICs, but not raw materials such as copper bars or paint. The outside suppliers' share of finished products was 21% and 22% for 1978 and 1979, respectively. Including components and subsystems raises the share to 31% and 34%. These are the official BSPPD figures.

TABLE 2

1979 TELECOM PRODUCT PURCHASES

Dollars in Billions

	1978	1979
BOC Direct	0.8	1.0
BOC thru WECo	0.7	0.8
Components for WECo Prod	0.7	1.0
Total	2.2	2.8

When the 1980 numbers are released, they will probably show that the general trade share of products continued at around 22% and that the volume of components and subsystems rose to about $1.4 billion.

Now, let's break the $7.1 billion Telecom Products Construction Budget for 1978 down into 11 product families to examine the details of general-trade sales (Table 3). These data are not available from BSPPD, but come from a comprehensive 1978 study prepared by Sonneville Associates of Crystal Lake, Illinois. The numbers have not been confirmed precisely by the BSPPD, but they seem to be reasonable.

TABLE 3

1978 TELECOM PRODUCT FAMILIES

Dollars in Millions

	Total	Gen'l Trade	% from Gen'l Trade
CO Switchers	2,100	200	10
Microwave	88	38	43
Transmission Equip	772	120	16
Cable & Wire	1,21[illegible]	100	8
Station Apparatus	1,471	200	14
Large PBXs	250	10	4
Poles & Hardware	86	86	100
Conduit	200	200	100
System Minicomputers	150	150	100
Office Computers	70	70	100
Supplies	392	392	100
Total	7,155	1,666	23

Central office switching dominates. We suppliers have a 10% share, but I suspect that this is primarily ancillary switching products such as message-accounting, traffic-measuring and test equipment. The amount of basic switching equipment procured from sources other than WECo has been and is negligible. This spring, both Northern and ITT have cut over digital switches for New York TelCo. ITT's System 12 exchange with a co-located remote subscriber unit was put into traffic in Syosset, New York on February 28. Installation was done by WECo craftsmen under ITT supervision and from the reports of the NY TelCo management, the performance is excellent. Obviously, we are pleased and we look forward to increasing our portion of that 10% share of the Bell System market in coming years.

The $88 million of microwave equipment is a low-volume product requirement for the Bell System. The 43% captured by the general trade would be small business for WECo, but it is a major business segment for a specialist company such as, say, California Microwave. Recently, this segment has been growing rapidly.

Transmission includes multiplex and line equipment. Of the $772 million in 1978, $120 million went to the general trade. A significant fraction of this consisted of digital channel banks and repeaters from ITT. This market share is getting smaller. Translation: WECo is becoming more competitive.

Transmission products offer an example illustrating how a combination of factors is decreasing some market windows for the general trade. First—product life is down—now typically six to eight years. ITT modestly considers itself a leader in transmission technology. We are second in sales worldwide only to WECo. We have the latest technology available, but we can't start to develop the final product until we get the specifications. WECo develops its products in close collaboration with the BOCs. Only when the development is complete and the product is accepted by the BOCs and in production, are the specifications released to the non-Bell world.

The cycle for development and the establishment of volume product takes a minimum of two years. Qualification testing, field trials, and acceptance of the product as "Suitable for the Bell System" take a minimum of 18 additional months. As a result, the market life for a general trade product is typically down to four years versus seven years for WECo. This is such a significant competitive disadvantage that general trade suppliers are essentially precluded from selling to BOCs those products that compete head-to-head with WECo.

Cable and Wire is a WECo strength. ITT manufactures telecommunications cable in eight countries, but in the U.S. we compete with WECo only in the new area of optical fibers. Market research projects telecommunications cables as a shrinking business, so we can expect WECo to fight very aggressively to maintain volume in its factories.

Station apparatus includes telephone subsets, key systems and smaller PABXs. It is the second largest product family, comprising 70% of switching in 1978 but growing rapidly. I would expect that the figures for 1979 and 1980 will show WECo and the Bell System continuing to lose market to "interconnect" companies, including ITT.

In March 1982, the Bell System will be required by the FCC to handle new customer premise equipment through a nonregulated, arms-length subsidiary. We can expect significant changes in market positions. I can't resist the temptation to report to you that ITT's Telecommunications Division in Canada has signed a nonexclusive distribution agreement with Bell Communications Systems, Inc., Canadian Bell's nonregulated interconnect company. BCS will sell ITT's new System 3100. This hybrid key system and PABX won out in competition with Northern and Mitel in the 40-to-120-line range. You all know that Bell Canada is no longer a subsidiary of AT&T, but we hope that some of the BOCs will follow the example of their Canadian cousin in the years ahead.

Large PBXs totaled $250 million, with only 4% coming from the general trade. Some of this was ITT. A more meaningful figure would include interconnect sales in BOC territories as part of the general trade market share.

For these six product categories, the general trade competed with WECo—and not very successfully. This contrasts with PABXs, for which the general trade has carved out a 35% market share in competition with the BOCs.

For the last four product categories and miscellaneous, we scored 100%. ITT is a major supplier of telephone poles. DEC provides minicomputers used in network systems such as message accounting, network management and maintenance diagnostics processing, but this category does not include computers used in main-line switching projects, which are classified under central office switches.

Sonneville shows 23% market share for the general trade, 2% higher than the BSPPD number. For the network and end-user products, the $5.9 billion for the first six categories, the general trade share is only 11%.

So much for the market; now a few words on the regulatory and legal environment.

In 1977, the FCC concluded that the Bell System should open its market to the general trade. I have extracted three statements from the FCC's findings:

- A "...bias in favor of Western products [which] limits not only the autonomy and independence of the BOC's, but also precludes a fair opportunity for the general trade to serve BOC's equipment needs."
- "...the overall Bell System procurement and make/buy decision processes, in which BSPPD participates, inherently favor Western."
- "AT&T has never developed any management structure to insure either that the products of the general trade manufacturer will receive fair and serious consideration for use in the Bell System or to insure that operating companies do purchase the best available equipment whatever the source."

Naturally, I would not disagree with the FCC on this matter. The record stands.

How did the Bell System react to the FCC's conclusions? This is the way it looked to us. WECo continued its close relationship with the Bell Labs and the operating units—a relationship highly privileged compared to the position of the general trade suppliers.

BSPPD increased its manpower, but in all fairness it must be said that the crucial "buy decisions" are with the line organizations—and rightly so. BSPPD tries to help but we all know that line organizations like to show their independence of staff groups.

AT&T proposed a new "procurement entity" which was to be more of a line-type organization and would actually do procurement for BOCs in a manner somewhat similar to the way WECo does some buying for the BOCs. The FCC was not convinced that this would be a step forward and nothing has been done to implement the proposal.

Lastly, most significantly, and not unexpectedly, WECo has become more competitive. If the objective of the general trade were to increase its sales of product families in competition with WECo, one might conclude that challenging the Bell System's procurement policies turned out to be counterproductive.

There continues to be high visibility for major litigation concerning Bell System procurement practices. You all know that AT&T and ITT settled an antitrust suit a year ago. The details are in the record.

Procurement policies and the role of WECo in the Bell System are major issues in the Justice Department's current antitrust suit. Many lesser law suits have been settled out of court. But one thing is sure—the relationship between BOCs, WECo and the general trade will continue to evolve and no one can predict the precise market environment even for as little as two years ahead.

I would like to conclude by listing four areas for continuing attention:

- **WECo is changing. We can expect the organization and its actions in the marketplace to become increasingly competitive, perhaps acting more like us general trade suppliers.**
- **The availability of multiple sources of supply for the BOCs might be expected to encourage local operating management to take more aggressive actions to reduce costs and improve services to us all—the subscribers.**
- **We all operate more efficiently under the spur of competition. There is no reason to assume that the units in the Bell System are different from the rest of us.**
- **And lastly, the Bell System is and will continue to be a large customer. We general trade suppliers should observe the changing patterns in the four market categories that I defined earlier—commodities, niche products, network products and customer premise equipment—and we should design our strategies to make the most of the Bell System market opportunity with realistic evaluation of the needs our products can fill in that market.**

INTRODUCTION OF WITNESSES

Mr. Chumbris. We will now hear from our last panel:

Mr. Thomas L. Thompson, Independent Data Communications Manufacturers Association, Washington, D.C.; Warren E. Burton, Association of Data Processing Service Organizations, Arlington, Va.; and an old-time friend and usual testifier to this subcommittee, A. G. W. Biddle, president, Computer and Communications Industry Association, Arlington, Va.

We will start with Mr. Thompson.

STATEMENT OF THOMAS L. THOMPSON, DIRECTOR, INDEPENDENT DATA COMMUNICATIONS MANUFACTURERS ASSOCIATION, WASHINGTON, D.C.

Mr. Thompson. Thank you.

My name is Thomas Thompson. I am a director of the Independent Data Communications Manufacturers Association, Inc. and special assistant to the president of General DataComm Industries, Danbury, Conn.

We are pleased by your interest in telecommunications issues. The structure of our industry and the conduct of its largest participant raise significant antitrust issues which you are particularly well-suited to address.

Your expertise is all the more essential, considering current proposals to modify an existing antitrust consent decree and to prescribe a structure for A.T. & T. substantially different from what the Justice Department seeks in its *Sherman Act* case.

Members of IDCMA are specialized, fast-growing, and intensely competitive manufacturers of equipment essential for data communications. Such equipment includes modems, data multiplexers, and network diagnostic equipment.

The makeup of the data communications equipment industry is generally as follows:

IDCMA members and other independent companies develop, manufacture, and market their equipment on an unregulated basis.

Some is sold to carriers for provision to their customers and to end users who use the transmission facilities of non-Bell carriers.

The vast majority, however, is sold to customers who use equipment with telecommunications facilities operated by A.T. & T..

A.T. & T.'s manufacturing affiliate, Western Electric, also manufactures modems. These are offered under tariffs, regulated by the States and the FCC.

Today the market for data communications equipment is competitive and highly innovative. This innovation has largely been by independent manuacturers. A.T. & T. has been a follower and not a leader.

Competition, to the extent it exists, has been possible because regulatory rules have evolved which to some extent inhibit A.T. & T. from improperly exploiting its monopoly-derived power.

Crucial to this progress have been the regulatory oversight of A.T. & T.'s pricing through review of tariffs and the decisions requiring A.T. & T. to permit the interconnection of customer-provided equipment.

There has been a great deal of debate about the appropriate structure for the unique telecommunications industry. Such discussion has rightly focused on A.T. & T., given its overwhelming dominance of the industry.

If the full potential of competition is to be realized, A.T. & T.'s abuses of its monopoly power must be eliminated.

It must be emphasized that A.T. & T.'s power has evolved because of Government-granted monopoly franchises. As a direct result of this protection from, as well as A.T. & T.'s resistance to, competition, A.T. & T. today has massive market shares in telephone transmission services and many equipment markets.

Even where it does not have a monopoly position in a specific equipment market, A.T. & T. can provide anticompetitive advantages to Western Electric through its control of essential transmission facilities.

I shall briefly outline the principal mechanisms by which such abuses can occur.

First, there is cross-subsidy. A.T. & T. can use its monopoly revenues to subsidize its entry into competitive activities. By misallocating research and development or other costs, it can further underwrite its competitive efforts at the expense of the monopoly ratepayer.

Next there is information flow. Designers of data communications equipment must know the technical characteristics of the network. A manufacturer who has more complete or timely information about these operating characteristics or planned changes for the network has a significant advantage in the marketplace.

Western can, and in fact does, get such information about the network long before independent manufacturers get it.

Additionally, there is tying. As noted, A.T. & T. controls bottleneck transmission facilities. It can use this control to favor its affiliates or their customers. Discrimination can occur in the quality of circuits provided or in the time in which service is initiated or restored.

Mr. CHUMBRIS. Would you suspend for a moment, please?

Senator Specter is on his way over here. I think he will be here within a few minutes, and I think he would like to hear the rest of your testimony and the testimony of you other two gentlemen.

We will recess for about 5 minutes.

[Recess taken.]

Senator **Specter** [acting chairman]. Good afternoon, ladies and gentlemen. We shall resume this hearing with a brief explanation and/or apology as you like.

We regret on the Judiciary Committee that it is not possible to run these hearings in a cohesive way, but the obligations of the members of the Senate are very extensive and simply preclude our being here at all times.

On this particular day, the Department of Justice budget is before the Senate. It is occupying the attention of Chairman Thurmond and quite a number of others.

That has been interrupted by consideration of the State Department budget and the Department of Justice budget.

There has been a controversial amendment to limit the authority of the Department of Justice on the busing issue.

I say that by way of a brief explanation as to why there is neither the appearance nor the reality of more cohesiveness, in terms of attention by the Judiciary Committee.

I want to assure you that the committee is very concerned about this problem. We will give it the maximum amount of attention that we can.

As you know, the Judiciary Committee functions, to a significant extent, through the cohesive quality of the staff, which is excellent on these matters.

By saying that, I do not mean to suggest that the senators do not give close attention to the product of the staff work, and it will receive our attention as promptly as we can take the matter up.

In light of the recess and the shifts of the Chair, I thought that you were entitled to that word of explanation.

Now I believe we were at page 7 of your prepared statement, Mr. Thompson.

Mr. **Thompson**. That is correct, Mr. Chairman.

If I may, I would like to go back and summarize the portion of my statement that I have already presented and then conclude.

Senator **Specter**. I think in light of the shift in the chair that a summary of what you have testified to would be in order. I would suggest to you that you summarize the balance as well.

Mr. **Thompson**. Thank you.

We are pleased by your interest in telecommunications industry issues. The structure of our industry and the conduct of its largest participant raise significant antitrust issues which you are particularly well qualified to address.

Your expertise is all the more essential, considering current proposals to modify an existing antitrust consent decree and to prescribe a structure for A.T. & T., substantially different from that which the Justice Department seeks in its *Sherman Act* case.

There has been a great deal of debate about the appropriate structure for the unique telecommunications industry. Much discussion has rightly focused on A.T. & T., given its overwhelming dominance of the industry.

If the full potential of competition is to be realized, A.T. & T.'s abuses of its monopoly power must be eliminated. It must be emphasized that A.T. & T.'s power has evolved because of Government-granted monopoly franchises.

As a direct result of this protection from, as well as A.T. & T.'s resistance to, competition, A.T. & T. today has a massive market share in both telephone transmission services and equipment.

Even where it does not have a monopoly position in a specific equipment market, A.T. & T. can provide an anticompetitive advantage to Western through its control of essential transmission facilities.

I will briefly outline those mechanisms.

First, there is cross-subsidy. A.T. & T. can use its monopoly revenues to subsidize its entry into competitive activities. By misallocating research and development or other costs, it can further underwrite its competitive efforts at the expense of the monopoly ratepayer.

Next, there is information flow. Designers of data communications equipment must know the technical characteristics of the network. A manufacturer who has more complete or timely information about these operating characteristics or planned changes to the network has significant advantage in the marketplace.

Western can, and in fact does, get such information about the network long before independent manufacturers get it.

Additionally, there is tying. As noted, A.T. & T. controls bottleneck transmission facilities. It can use this control to favor its affiliates or their customers. Discrimination can occur in the quality of circuits provided or in the time in which service is initiated or restored.

In short, A.T. & T. has an inherent conflict between its public responsibility as a provider of monopoly transmission services and its private interest in advantaging its competitive offerings.

To remove this conflict, A.T. & T. must be substantially restructured. Specifically, A.T. & T.'s regulated transmission services must be meaningfully separated from all aspects of its customer premises equipment business.

This is best accomplished through divestiture.

However, the A.T. & T. structure prescribed in the FCC's computer rules and in recent legislative proposals has been grossly inadequate.

At an appropriate time, the association would like the opportunity to address these problems in detail and to suggest remedies.

Thank you for allowing me to provide this brief sketch of the data communications equipment market. We request the opportunity to provide additional information for the record.

Senator SPECTER. Thank you very much, Mr. Thompson.

Your entire statement will be made a part of the hearing record.

We will now call upon Mr. Warren E. Burton, Association of Data Processing Service Organizations.

Mr. Burton, your statement has been received. It will be made a part of the record in full at the completion of your oral presentation.

The practice of this committee is to request that you summarize the testimony.

STATEMENT OF WARREN E. BURTON, VICE PRESIDENT, TYMSHARE, INC., AND MEMBER, ASSOCIATION OF DATA PROCESSING SERVICE ORGANIZATIONS, INC., ARLINGTON, VA.

Mr. BURTON. Thank you, Mr. Chairman.

My name is Warren Burton. I am vice president of Tymshare, Inc. We are members of the Association of Data Processing Service Organizations, more commonly known as ADAPSO, which is the trade association of the computer services industry.

We appreciate the opportunity to participate in these hearings.

My company, together with others in ADAPSO, is a member of a highly competitive, innovative, and thriving industry. The industry's participants, 11,000 in number, provide the American and worldwide public with a broad spectrum of computer services.

In 1981, our annual revenues will approach $20 billion.

These services include such diverse offerings as local batch processing; computer programs and programing services; software sales, design, and support; facilities management; and remote access data processing services.

In remote computing services, the connection between the customer and the computer is achieved through the use of common carrier communication services. These communications facilities are used to deliver data processing services to subscribers, much the same as the mails, trucks, and other means of transport are used to deliver physical goods to customers that are geographically distant from factories and stores.

Unlike vendors in other industries, however, remote access data processors are totally dependent upon one single means of transport to deliver their services to the public. Communications facilities, usually private line circuits, are our industry's lifeline.

Through its long lines department and its telephone operating companies, A.T. & T. exercises near exclusive control over access to the Nation's long-distance and local telephone networks, so that we are completely dependent upon A.T. & T. in order to provide our services to the public.

ADAPSO's concerns in this area are, therefore, a function of our dependence upon the availability of high quality and reasonably priced communications services.

Senator SPECTER. We understand your reliance there, as you have explained it and as your statement sets it forth in some detail, Mr. Burton.

Do you think it likely that A.T. & T. would become a competitor of yours?

Mr. BURTON. Is it likely that they will become a competitor?

Senator SPECTER. If deregulation occurs and if they are not prohibited by law from being a competitor, will they become a competitor of your particular line?

Mr. BURTON. I would say absolutely.

Senator SPECTER. What is the answer to that? What do you suggest should be done? Divestiture?

Mr. BURTON. Divestiture is the only sure and complete way of doing it.

Senator SPECTER. Do you think divestiture is really satisfactory? Once divestiture occurs, is there the absence of the kind of contacts between those parts which used to be one to give you adequate protection?

Mr. BURTON. If you have separately owned companies, the stockholders would control that I would think.

Senator SPECTER. You think that would be adequate.

Mr. BURTON. If you have separate stockholders, yes, sir.

Senator SPECTER. And if not adequate, it is the best that can be done.

Mr. BURTON. I think divestiture would be adequate.

Senator SPECTER. Is there any other essential point that you want to make today?

Mr. BURTON. Yes.

A.T. & T., as both a competitor and supplier of our services, has access to all of our customer lists. They physically come into our facilities and maintain their equipment.

Senator SPECTER. How do you protect your company against that if A.T. & T. becomes a competitor, or one facet of it?

Mr. BURTON. Barring divestiture or some other means, I do not know how you protect against it.

Senator SPECTER. Legislation which would prohibit their use of the secrets acquired when they were servicing you, penalties, fines, or court orders?

Mr. BURTON. I think that it would be fairly naive to think that information would not flow up through the organization.

Senator SPECTER. I have bad news. The buzzers just signaled a vote. In 7½ minutes, I am going to have to leave.

What other key point do you want to make, recognizing that others will not be heard at all. [Laughter.]

Mr. BURTON. Only to reiterate that our greatest concern is that if A.T. & T., which is now barred from going into the computer services industry, is allowed to enter that industry, some very severe restrictions would have to be placed upon them in entering our business.

Senator SPECTER. I think we understand that, Mr. Burton.

We will insert your full statement into the record.

Senator SPECTER. Mr. Biddle, I would like to hear from both you and Mr. Erb, because I do not think we are going to be able to reconvene this hearing.

Mr. Erb, would you come forward and be in a position to testify when Mr. Biddle concludes?

We have your statement, and it is a very extensive statement, Mr. Biddle, so I think it would be most helpful to the committee if you would just give us the highlights of what it is you want us to understand.

STATEMENT OF A. G. W. BIDDLE, PRESIDENT, COMPUTER & COMMUNICATIONS INDUSTRY ASSOCIATION, ARLINGTON, VA.

Mr. BIDDLE. Thank you, Senator.

I think the main thing that has to be addressed in this whole issue is that A.T. & T. has been a rapidly growing company since the end of World War II.

At the end of World War II, less than 20 percent of the homes in this country had telephones. In the meantime, they filled that gap.

In the process, that vacuum now has been filled. They are looking for ways to diversify into new growth areas.

Faced with the potential divestiture called for in the previous antitrust suit, they entered into an agreement with the Department of Justice that in order not to divest themselves of Western Electric, they would remain solely a regulated common carrier.

They have now come to the Congress and the FCC and said: Wait a minute. We want to renege on that deal we made. We want to be deregulated like trucks and airlines and be free to compete with anybody.

In part, their justification was that the FCC, had allowed IBM, through its satellite business systems, to compete with A.T. & T. It is only fair that A.T. & T. be permitted to compete back, they argued.

Senator **Specter**. If that occurs, is divestiture a sufficient remedy, in your opinion, Mr. Biddle, to protect your interest?

Mr. **Biddle**. We have felt that divestiture so far in this Congress has been considered an unacceptable solution, because it implies punishment and a taking away. We strongly urge that A.T. & T. be set up into two totally separate corporations, and that shares of stock in the new company, which is the competitive entity, be distributed to A.T. & T. shareholders.

They are A.T. & T.—not the managers at 195 broad.

Senator **Specter**. You think that would be adequate.

Mr. **Biddle**. We believe, largely, that it would be adequate; but I would want you to understand that if you consider that to be a bar chart of corporate revenues in this industry, A.T. & T. would be at the ceiling with $55 billion a year in annual revenue; IBM would be down here at this lamp at $26 billion.

When I said $55 billion, I did not count the $13 billion of Western Electric which A.T. & T. never reports in the same statement.

It is really $69 billion that is the A.T. & T. entity that we are expected to compete with.

Senator **Specter**. Is there any remedy, short of divestiture, which would be adequate, in your opinion?

Mr. **Biddle**. As a businessman of some 25 years standing, I can assure you that if you try to impose regulations to prevent me from using my market power in this monopoly area to the detriment of my competitors, I will find a way around it, just as they have found continuing ways around every rule and every tariff that the FCC has tried to impose on them.

Senator **Specter**. Your first preference is that they not be permitted to compete.

Mr. **Biddle**. No; we have no concern about competing with them. We have lived in the shadow of IBM now for two decades. IBM is 20 times larger than their nearest competitor.

Senator **Specter**. Which is your first preference—that they not compete with you or that they compete through divestiture?

Mr. **Biddle**. From the national interest, we welcome them into the industry. Therefore, I say that our first choice is divestiture. We have no desire to keep them out of the market per se, any more than we have been before this committee asking to keep Exxon out of our market.

That is fine, but you cannot have control over a vital raw material of our industry, which is telecommunication services, and at the same time be a competitor.

Senator **Specter**. I am very sorry to abbreviate your testimony, Mr. Biddle.

I do not know what is going to happen on the floor, because I have not been there for about half an hour. The odds are good that I will not be able to get back here before 5 o'clock, and I would like to leave Mr. Erb, president of Millicom, with just a moment or two here.

We will insert the statement of Mr. Biddle, and we will proceed with Mr. Erb.

STATEMENT OF PETER F. ERB, PRESIDENT AND CHIEF EXECUTIVE OFFICER, MILLICOM INC., NEW YORK, N.Y.

Mr. **Erb**. My statement is really quite brief.

In the last few years, a new technology has evolved, the cellular radio technology, which was really not any new invention or any big R. & D. achievement. It was simply an outgrowth of the computer industry, producing data processing equipment powerful and economical enough to drive this particular system. The system is fully capable of replacing the present wire line local loop distribution system if it is fully and properly exploited.

While we are sitting here, trying to reduce the monopoly position of A.T. & T., A.T. & T. is so well-organized that through the back door they have made sure to expand this monopoly position by persuading the FCC to give them half of the frequencies allocated, free of all encumbrances and free of all competition for a new monopoly basis.

By this action, they are scuttling the possibility of having a competitive alternative to the local loop.

In the next few years, as technology advances, undoubtedly, there will be other techniques available which will be competitive to the local loop.

I am sure that the very agency which was set up to protect the general public from the excesses of the monopoly will find ways to scuttle them also. That is really my point.

They have created by their rulemaking on April 9 a situation——

Senator **Specter**. By "they" you mean who?

Mr. **Erb**. The FCC.

They were advised by A.T. & T. no doubt.

They created a situation where this new technology, instead of a general public type of service, will become a special interest type of service for people who can afford the $155 or more per month, in addition to the telephone bill, plus sit in a car.

As a matter of fact, a vice president of A.T. & T., Mr. Billingsly said: These people are very happy to pay $155 extra on their telephone bills.

The commissioners have stated that the only reason they gave half to A.T. & T. was that this was the only way to get the service to the public quickly.

If they perceive the public to be a person who can afford $155 a month and sit in a car, then maybe I am in the wrong place.

Senator **Specter**. And maybe the rest of us are too.

Mr. **Erb**. Precisely.

Senator **Specter**. Thank you very much, gentlemen.

We will insert in the record also the statement of Mr. Erb.

[The prepared statements of Messrs. Thompson, Burton, Biddle, and Erb follow:]

PREPARED STATEMENT OF THOMAS L. THOMPSON

Mr. Chairman and Members of the Committee, my name is Thomas L. Thompson. I am a director of the Independent Data Communications Manufacturers Association, Incorporated (IDCMA) and Special Assistant to the President of General DataComm Industries, Inc. of Danbury, Connecticut.

On behalf of the IDCMA member companies, I thank you for this opportunity to testify. My statement will address the structure of the data communications equipment industry. It will review for you the role of the independent companies like members of IDCMA and the role of the American Telephone and Telegraph Company (AT&T) in that industry.

We are particularly pleased by the interest of your Committee in telecommunications issues. The structure of our industry and the conduct of its largest participant raise significant antitrust issues which you are particularly well qualified to address. Your expertise is all the more essential in the consideration of proposals to modify an existing antitrust consent decree and to prescribe a structure for AT&T that is substantially different from the structure we expect to result from the Government's pending Sherman Act case.

Member companies of IDCMA [1] are specialized, fast growing, and intensely competitive manufacturers of equipment essential for data (computer) communications. Such equipment includes modems (which permit computers to "talk" to one another over telephone lines), data multiplexers (which allow for more efficient use of transmission circuits), and network diagnostic equipment.

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[1] Other IDCMA member companies include: Codex Corp., Mansfield, Massachusetts, ComData Corp., Morton Grove, Illinois; Intertel, Inc., Andover, Massachusetts; Infotron Systems Corp., Cherry Hill, New Jersey; Racal-Milgo, Inc., Miami, Florida; Racal-Vadic, Inc., Sunnyvale, California; Universal Data Systems, Inc., Huntsville, Alabama.

Since its inception a decade ago, IDCMA has been actively involved in the effort to promote full and fair competition in the communications equipment marketplace. IDCMA has participated in a variety of proceedings before the Federal Communications Commission (FCC), state public utilities commissions and the federal courts. IDCMA representatives also have testified before both Houses of Congress on various communications bills when opportunities to testify were provided.

The market structure for data communications equipment may be generally described as follows: IDCMA members and other independent companies develop, manufacture, and market their equipment. Some is sold to carriers for provision to their customers. Some is sold to end-users for use in conjunction with the transmission facilities of non-Bell carriers. However, the vast majority of it is marketed to customers who use the equipment with telecommunications facilities operated by AT&T.

AT&T's manufacturing affiliate, Western Electric, also manufactures modems, which they call "data sets." Bell Telephone Laboratories provides the applied research and product development for this effort. These data sets are presently marketed by AT&T and the Bell Operating Companies under tariff. While AT&T companies do market some other types of data communications equipment not manufactured by Western Electric, the Western Electric-manufacturered equipment represents by far the largest amount of data communications equipment marketed by AT&T.

Today, the market for data communications equipment is competitive and highly innovative. This innovation has largely been initiated by independent manufacturers. 2/ In this regard, AT&T has been a follower, not a leader.

2/ See, e.g., Amendment of Section 64.702 of the Commission's Rules and Regulations (Second Computer Inquiry), Final Decision, 77 FCC 2d 384, 440 (1980) (independent vendors have been "the primary leaders" in terminal equipment innovation). See also Appendix A (IDCMA position paper on innovation).

Competition, to the extent it exists, has been possible because of the innovative character of companies like the IDCMA members and because regulatory rules have finally evolved after many years which to some extent inhibit AT&T from improperly exploiting its monopoly-derived power. Crucial to this progress have been the regulatory oversight of AT&T's pricing through review of tariffs and the decisions requiring AT&T to permit the interconnection of customer-provided equipment.

There has been a great deal of debate about the appropriate structure for the "telecommunications" industry. Much discussion has focused on AT&T. This attention is absolutely necessary given AT&T's overwhelming dominance of the telephone transmission and equipment markets. Issues relating to AT&T are also being considered in other forums, such as the antitrust courts. For example, the propriety of AT&T's responses to competition is currently being reviewed in the United States District Court for the District of Columbia in the Government's antitrust case. 3/ The record being developed in that proceeding should shed further light on these matters. 4/ Over the years, the Federal Communications Commission has also addressed these issues and has found AT&T's conduct unlawful or anticompetitive in many respects.

It is important to focus on the position of AT&T because AT&T has the power to eliminate competition. It has this power by virtue of its control over the nation's telecommunications network. The control of this network permits AT&T to control

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3/ See United States v. AT&T, Civ. No. 74-1698 (D.D.C., filed Nov. 20, 1974).

4/ Probably the most detailed record of AT&T's predatory conduct has been compiled in the Justice Department's massive antitrust lawsuit against AT&T. See Plaintiff's Third Statement of Contentions and Proof, filed Jan. 10, 1980, in United States v. AT&T, Civ. No. 74-1698 (D.D.C., filed Nov. 20, 1974). Much of this evidence has been "presifted" in the sense that the conduct on which the charges are based is conduct that the FCC and/or courts have already found unlawful. (A very brief summary of the most recent Statement of Contentions and Proof is attached as Appendix B.)

other markets, especially those (like the data communications equipment market) which are dependent upon telecommunications facilities. Therefore, if the potential of competition is to be fully realized, AT&T's monopoly power must be eliminated or at the very least controlled.

It must be emphasized that AT&T's power evolved by virtue of the many years AT&T has enjoyed government-granted monopoly franchises. As a direct result of its historic protection from, and resistance to, competition, AT&T today has overwhelming market shares in telephone tranmission services 5/ and many equipment markets. 6/ Even where it does not have a monopoly position in a specific telecommunications equipment market, AT&T has the power to dominate that market through the exercise of its control over essential transmission facilities. In this regard, it must be kept in mind that virtually every telecommunications user is dependent upon facilities controlled by AT&T. AT&T can use its control of these facilities to assure that anticompetitive advantages accrue to Western Electric. I shall briefly outline the mechanisms by which such abuses can occur.

(a) Cross Subsidy: AT&T derives most of its revenues from monopoly services. It can directly use these monopoly revenues to subsidize its entry into competitive activities. 7/

5/ See Telecommunications Act of 1980: Hearings on H.R. 6121 Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary, 96th Cong., 2d Sess. 516 (1980) (statement of Charles D. Ferris, Chairman, FCC) (AT&T has about "a 90% share of the private line transmission services"). AT&T's market share is equally overwhelming in local distribution facilities and intercity switched network facilities.

6/ Id. (AT&T has approximately "a 60% share of the [total] terminal equipment market.") Of course, in a number of submarkets, such as telephone handsets, AT&T's market share is much higher. These figures reflect current shipments, but do not take full account of AT&T's huge base of embedded terminal equipment.

7/ For example, using a License Contract (which levies a charge based on a percentage of revenues from monopoly services) to pay for developing competitive sector equipment. See Application of Pacific Tel. & Tel. Co., Decision No. 90362 (Cal. Pub. Util. Comm'n, June 5, 1979). In a related proceeding the California Public Utilities Commission strengthened its position regarding license contracts. See also Report on the Affiliated Relationships of the Pacific Tel. & Tel. Co. with AT&T General Dept., et al., Application No. 59849 (Cal. Pub. Util. Comm'n, Oct. 9, 1980).

It can further subsidize its competitive offerings in a more indirect manner. Western Electric manufactures equipment for both the monopoly telephone network and for competitive markets, such as data communications equipment. By misallocating research and development or other costs, it can underwrite its competitive efforts at the expense of the monopoly ratepayer. Experience has shown that accounting conventions alone are not adequate to police or correct the abuses from unified operations.

(b) Information Flow: Since data communications equipment must work over the telephone network, manufacturers of data communications equipment must have information about the technical characteristics of the network. Any manufacturer who has more complete information or more timely information about these operating characteristics or planned changes to the network has a significant advantage in the marketplace. Such information will affect the cost or the design of its products. Western Electric, as AT&T's manufacturing affiliate, can and in fact does get information about the network long before independent manufacturers (if, indeed, such information is ever disclosed to nonaffiliates). This gives Western a substantial competitive edge -- one totally unrelated to its own skill.

(c) Tying: As noted above, AT&T controls transmission facilities that virtually every user must employ. Therefore, it has control of a "bottleneck." It can use this control to discriminate in favor of its affiliates or customers of its affiliates. Conversely, it can use this control to penalize its competitors or their customers. AT&T's control of this essential resource enables it to vary the availability and quality of service depending on the customer's selection of data communications equipment (or other products or services). This discrimination can occur in the quality of circuits provided or in the time in which service is initiated or restored.

In short, AT&T has an inherent conflict between its public responsibility as a provider of monopoly transmission services and its private interest in advantaging its competitive offerings.

To remove this conflict, and to preserve the rapid innovation and favorable U.S. balance of trade that independent data communications manufacturers are contributing, AT&T must be substantially restructured. Specifically, AT&T's regulated transmission services must be meaningfully separated from all aspects of its customer-premises equipment business. This is best accomplished through divestiture, which is the remedy sought by the Justice Department in the Government's pending antitrust case.

By way of contrast, the approaches to AT&T structure prescribed in the Commission's Computer Rules and in recent legislative proposals have been grossly inadequate. Neither the Commission's decision nor the recent Senate telecommunications bill even purports to alter AT&T's incentives to abuse its monopoly power. Moreover, even as "second best" surrogates, both fail to really provide the structural separation claimed. A detailed analysis of these shortcomings is beyond the scope of this hearing. 8/

At an appropriate time, the Association would like the opportunity to address these problems in detail and to suggest appropriate remedies for consideration.

Thank you again for allowing me to provide this brief description of the data communications equipment market. We request the opportunity to provide additional information for the record. I am prepared to respond to questions.

8/ However, by way of example: S. 898 claims to require that AT&T offer customer-premises equipment on an unregulated basis through a "fully separated affiliate." However, the bill permits AT&T to permanently use an unseparated organization to develop and manufacture the key elements -- components and subassemblies -- of that equipment. Section 228(e)(3)(4). The FCC Computer Rules do not require any separation of the research, development or manufacturing elements of AT&T's CPE business. See 47 C.F.R. § 64.702 (1980).

APPENDIX A

IDCMA
INDEPENDENT DATA COMMUNICATIONS MANUFACTURERS ASSOCIATION, INC.
1735 New York Avenue, N.W., Washington, D.C. 20006 Telephone (202) 833-9800

The problems presented to Congress dealing with the proper regulation of the nation's telecommunications network are discussed in a series of papers prepared by the Independent Data Communications Manufacturers Association. This paper, one in the series, addresses the importance of independent manufacturers as the source of major technological innovations and progress in the telecommunications industry.

POSITION PAPER: INNOVATIONS

A consensus is growing that competition in the telecommunications industry has benefited the country and will continue to do so. This has long been recognized by the competitive sector of that industry and by the consumers of telecommunications services and products. It is being argued that new legislation is needed to preserve and expand these benefits. Clearly, there has been major technological progress, much of it engendered by small, highly innovative companies.

Although the resources of the independent manufacturing companies are small in comparison to the resources of AT&T, the Federal Communications Commission, the courts, and the Department of Justice all have recognized that the independent manufacturing companies, rather than AT&T, are the entities which have responded dramatically to the increasing demand for sophisticated data equipment.

THE INDEPENDENTS' ROLE

Innovations in computer communications equipment and services are of tremendous importance to consumers and ratepayers. Over the years, independent companies have provided much of the drive behind the acceleration of technological advances. When the history of the computer communications industry is examined, several facts important to the development of future policy become clear. The computer communications equipment and services industry has a demonstrated record of innovation, accomplishment and service to the public. This record has been compiled without the aid of AT&T.

Despite AT&T's massive economic power and research capability and its repeated efforts to eradicate competition from the marketplace, competition is taking root, new technologies are sprouting, and consumers are reaping the benefits.

Information processing has gone through multiple generations of equipment and software and has repeatedly reduced costs to the using public. Innovations in medical, business, and public information systems have all been brought about by the non-monopoly information processing industry and by independent providers of communications equipment and services.

COMPETITION CURTAILED

Competition in the computer communications equipment market emerged only because the government repeatedly intervened to make AT&T stop its unwarranted interference with the subscriber's right to reasonably use his telephone in ways which are privately beneficial without being publicly detrimental. AT&T has continued its relentless efforts to justify inhibiting competition. Its arguments have been examined, and found baseless.

AT&T's resistance has made it difficult for the small competitor, but innovations by independents have still come at a rapid rate. For example, in response to the demand for higher speed modem equipment, a 4800 bps (bit per second) modem was offered by an independent manufacturing company in 1965; AT&T did not duplicate this offering until 1972. By 1968-69, independent companies introduced 9600 bps modems, a feat not achieved by AT&T until 1974. Higher speed devices permit more economic computer communications and more efficient use of basic telecommunications facilities.

Independent companies have collectively contributed to the development of many testing and diagnostic features (including automatic remote diagnostics that can automatically check equipment at unattended user locations) enabling the using public to maintain direct control over their communications network.

Other terminal equipment innovations in which independent companies have played a major role include teleprinter equipment, CRT display terminals, remote batch terminals, point of sale terminals, banking terminals, credit card authorization systems, telephone and recording systems, facsimile equipment, and call dispatchers and toll restrictors.

NON-PROGRESSIVE POSTURE

Indeed, AT&T has often ignored markets because they are too small to warrant its attention. An AT&T executive noted:

> *Or, expressed in more colorful terms, we are going to appeal to a broader based market for, say, chocolate and vanilla ice cream and leave it to others, to satisfy customers whose tastes run to less popular flavors like pistachio and tutti-frutti (S.E. Bonsack, **Marketing Functions in Competitive Telecommunications**, Vol. 92 PUBLIC UTILITIES FORTNIGHTLY, August 2, 1973 at 14).*

Yet, the customer needs specialized applications. This is particularly true in areas of rapid technological change and innovation.

The public has received many benefits, including availability of new equipment features, improved reliability, and installation features. These benefits have come from independent companies and not AT&T. Indeed, they have often come about it spite of AT&T's opposition.

Such success demonstrates the lack of compelling need for AT&T to participate in either the information processing or the data communications equipment and services industries.

INFORMATION TRANSPORT

In marked contrast to the information processing and data communications equipment industries, the rate of innovation within the information transportation industry has lagged badly. In fact, the most flexible, advanced means of transporting information are provided by non-monopoly specialized common carriers that have adapted existing telecommunications facilities into specialized networks for more efficient transportation of information. This small group of competitors during its short lifespan has managed to make a giant imprint on one of the nations largest industries:

(i) Packet switching is available for data handling;
(ii) Satellite communications is available;
(iii) The first all digital transmission system for truly accurate high-speed transmission is not an AT&T facility, but a specialized carrier;
(iv) A large number of systems in use today are custom-designed to perform sometimes unique customer's needs more efficiently;
(v) New areas of communications such as facsimile are being offered to improve the customer's communications efficiency.

IMPORTANCE OF ADVANCEMENT

Obviously, the continuing advancement of telecommunications technology and the resulting expansion of consumer choices depend on the continued growth of the competitive environment. At a time when the communications laws are being reconsidered and possibly rewritten, it is crucial to provide safeguards which prevent AT&T from using its awesome resources to curtail competition. Without structural changes in AT&T, continued regulatory and judicial supervision of AT&T will be necessary to protect against predatory practices such as cross-subsidization and tying.

The Department of Commerce in 1977 published a report indicating that 45 percent of the Gross National Product was derived from the service industries. The report further indicated that the growth in this segment of the economy would be dependent in large measure on the growth of technology in the communications field. This leads one to wonder whether the public is willing to assign the fate of almost half the economy to one company, unregulated, particularly since in the past this company has not shown a strong indication to innovate in the new product area and has exerted strong efforts to inhibit competitive innovation.

APPENDIX B

United States v. AT&T

Third Statement of Contentions and Proof -- Volume I -- Summary

I. AT&T'S RESPONSES TO THE SPECIALIZED COMMON CARRIERS HAVE BEEN ANTICOMPETITIVE.

- AT&T has engaged in a pattern of conduct designed to maintain and expand its existing telecommunications service monopoly in violation of the Communications Act, Federal Communications Commission (FCC) policy, and the antitrust laws.
- AT&T has engaged in predatory pricing, refusals to supply transmission service, pre-selling, and other marketing and operational practices.
- Because of AT&T's intra-corporate structures and relationships, the Bell Operating Companies do not deal autonomously or even-handedly with non-Bell suppliers of telecommunications services.
- State and federal regulation are unable to deal effectively either with exclusionary and other anticompetitive behavior employed by AT&T to preserve and maintain its monopolies or with the basic underlying structural problem which creates the incentives for the anticompetitive conduct.

II. AT&T HAS EMPLOYED A VARIETY OF STRATEGIES TO PRESERVE AND MAINTAIN ITS MONOPOLY POSITION IN TELECOMMUNICATIONS SERVICE IN VIOLATION OF THE LAW.

- AT&T has abused the regulatory process at the FCC by using it as a vehicle for self-serving diliatory tactics.
- AT&T exhibited an unwillingness to negotiate in good faith.
- AT&T willfully submitted rate proposals without adequate cost support.
- AT&T refused to permit MCI into its Common Control Switching Arrangements (CCSA) network or to make the interconnections necessary to establish a Foreign Exchange (FX) type service.
- AT&T refused to lease facilities to the specialized carriers under the same terms as those in the Exchange of Facilities Contracts with Western Union even though it knew this was discriminatory and unlawful.
- AT&T exaggerated the problems of interconnection and represented that interconnection would cause severe and irreparable injury to the telephone system, even though it knew these problems were insub-

stantial and could be resolved satisfactorily without great difficulty.

- AT&T filed interconnection tariffs which continued to impose discriminatory rates and conditions on carriers competing with its Long Lines even after the FCC declared such tariffs unlawful.

United States v. AT&T

Third Statement of Contentions and Proof -- Volume II -- Summary

I. NON-BELL SUPPLIERS ARE FORECLOSED BY AT&T FROM SELLING THEIR EQUIPMENT TO THE BELL OPERATING COMPANIES.

- "The non-Western supplier never competes on equal terms."
- Problem mainly due to Western Electric's role in the evaluation and procurement of independently manufactured equipment.
- AT&T fosters Bell Operating Companies' dependence on Western for manufacturing, engineering specifications, installation, warehousing, and distribution.

II. AT&T MONOPOLIZES MARKETS FOR TERMINAL EQUIPMENT, CENTRAL OFFICE EQUIPMENT, and TRANSMISSION EQUIPMENT.

- Greatest detail -- literally hundreds of pages -- shows AT&T's efforts to restrict the use of non-Western terminal equipment.
- AT&T has resisted competition through many techniques, including:
    - refusals to allow connection of non-Western equipment,
    - bundling of equipment charges with transmission service charges,
    - predatory pricing,
    - premarketing of new equipment and service features,
    - disparagement of competitors' offerings,
    - harassment of competitors and customers of competitors, and
    - deliberate modification of the network.

III. NEED FOR STRUCTURAL SOLUTION IS REAFFIRMED:

- Only structural measures can remedy anticompetitive practices.
- Western Electric's manufacturing and Bell Labs' product research and development must be separated from the providers of telecommunications services.
- AT&T's intercity transmission facilities must be separated from the local facilities.

PREPARED STATEMENT OF WARREN E. BURTON

Mr. Chairman and members of the Committee:

My name is Warren E. Burton and I am Vice President of Tymshare, Inc. My company is a member of the Association of Data Processing Service Organizations, more commonly known as ADAPSO, which is the trade association for the computer services industry.

I want to thank the Committee for this opportunity to appear here today and to express both the views of ADAPSO and my company with respect to the status of competition in the computer services industry.

My company, together with others in ADAPSO, are members of a highly competitive, innovative, and thriving industry. The industry's participants, 11,000 in number, provide the American and worldwide public with a broad spectrum of computer services. In 1981, our annual revenues will approach $20 billion. These services include such diverse offerings as local batch processing; computer programs and programming services; software sales, design, and support; facilities management; and remote access data processing services.

These latter remote computing services enable geographically dispersed customers to access distant centralized computers for both interactive (timesharing) and batch data processing purposes. The connection between the customer and the computer is achieved through the use of common carrier communications services. In other words, communications facilities are used to deliver data processing services to subscribers, much the same way that the mails, trucks, and other means of transport are used to deliver physical goods to customers that are geographically distant from factories and stores.

Unlike vendors in other industries, however, remote access data processors are totally dependent upon one single means of transport to deliver their services to the public; communications facilities, usually private line circuits, are our industry's lifeline. As the members of this Committee are well aware, the overwhelmingly dominant provider of such service in the United States is the American Telephone and Telegraph Company ("AT&T"). Through its Long Lines Department and its telephone operating companies, AT&T exercises near exclusive control over access to the nation's long distance and local telephone networks. Consequently, remote access data processors such as my company are completely dependent upon AT&T in order to provide our services to the public.

ADAPSO's concerns in this area are, therefore, a function of our dependence upon the availability of high quality, and reasonably priced communications services. In today's market, in which the computer services industry stands in a customer-supplier relationship with AT&T, we encounter problems with respect to the cost, quality, and availability of service. If AT&T were permitted to become a competitor in the computer services industry without adequate competitive safeguards, and I want to stress the use of the qualifier "without adequate competitive safeguards", these problems would be compounded.

In such an environment, AT&T would have both the incentive and the opportunity to use its monopoly power and resources, and its control over the communications network, to destroy competition. As both a competitor and supplier of service to the computer services industry, AT&T would be uniquely situated to engage in tying and other forms of unfair competition. As the predominant provider of telecommunications service, AT&T could easily misuse privileged information about the network, its customers, and its customers' customers.

AT&T as a supplier of telecommunications services has been intimately involved in the operation of our businesses. For example, they have access to our customer lists and have their own personnel physically present in our timesharing facilities for maintenance purposes.

Similiarly, AT&T could manipulate the quality, availability, restoration, and maintenance of service for anticompetitive ends. Because of AT&T's dominance and its ability to establish de facto standards, AT&T could selectively structure protocols and other technical characteristics of communications service to favor its own data processing service offerings. Because of its enormous monopoly sector revenues, AT&T could, through cross-subsidization, win almost any competitive battle with a data processor. In short, AT&T could use its historic government-conferred franchise to support its competitive endeavors in unregulated markets.

Faced with the prospect of this reality, the computer services industry is naturally concerned with any legislative or agency action which would allow AT&T to enter our industry.

My company and others in ADAPSO share the view of the Justice Department in its antitrust suit that divestiture is the only completely satisfactory means of assuring that AT&T's entry into unregulated markets is not accompanied by anticompetitive abuse. In that suit, the government has alleged serious violations of the antitrust laws, and in which it has requested divestiture. The record in that case will be closed by the end of the year; a decision by the trial court can be expected shortly thereafter. At that time, Congress will have available a complete factual record, one that may suggest a course of action different from current legislative proposals. Any Congressional restructuring of the Bell System before the trial court renders its decision will compromise the suit; it will also undoubtedly affect the court's willingness to prescribe the relief that might otherwise be required by the facts.

AT&T is presently barred by the 1956 Consent Decree from entering unregulated competitive industries such as computer services. If AT&T is to be permitted to enter the computer services industry, ADAPSO is concerned on what basis they will be allowed to compete.

In closing, Mr. Chairman, I wish to stress that neither ADAPSO nor its members are unalterably opposed to AT&T's entry into the computer services industry. We ask only that AT&T be required to compete fairly, and that it be restrained through the imposition of stringent competitive safeguards from using its regulated monopoly power and resources, and its control over the communications network, for anticompetitive ends.

PREPARED STATEMENT OF A. G. W. BIDDLE

The Computer & Communications Industry Association represents the some 70 leading manufacturers and providers of computers, magnetic storage systems, printers, terminals, data communications equipment and services as well as data processing services. Our member firms range in size from under one million dollars in annual revenues to well over $500 million. Together they generate annual revenues in excess of $4 billion and employ over 100 thousand people in the United States. Most are less than a dozen years old, yet, almost without exception, they are the innovators in each of their respective fields of endeavor.

Individually, and as an Association these firms are deeply concerned about, and involved in the current policy debates relative to the future structure of the American computer and communications industries. During the past five years we have testified before relevant Committees of both the House and the Senate concerning deregulation of AT&T and the impact that that deregulation would have on the state of competition within these industries. We are also the lead plaintiff in the pending appeal of the FCC's Computer Inquiry II Decision before the D.C. Circuit Court of Appeals.

Contrary to the contentions of AT&T, our concern about, and our opposition to, the various proposals under consideration does not stem from an inability or unwillingness of our member firms to face new entrants into the marketplace and compete with them on the merits. Rather, it stems from the sincere belief that the current proposals have been based upon several erroneous assumptions. These are:

- That meaningful competiton exists today in the long distance telecommunications market.
- That AT&T must be freed from the restraints of the 1956 consent decree so that they can compete freely with IBM in the data processing equipment and services businesses.
- That AT&T will treat customers, who are also competitors, on exactly the same terms and conditions that they would treat their own wholly owned competitive subsidiary.
- That somehow, "the system is the solution" and therefore the provision of efficient information systems requires single company end-to-end ownership and operation.
- That adequate separation between the regulated monopoly and the competitive entity can be achieved through accounting separations and ongoing regulatory oversight.
- That AT&T has been restricted or restrained from exporting because of the Consent Decree and/or regulatory restrictions.

If I may, I would first like to focus on a few aspects of S. 898 in order to illustrate the concerns we have about this proposal and to underscore the further steps which must be taken to effectuate a changed national policy on telecommunications which provices a new role for AT&T. S. 898 would amend the common carrier provisions of the Communications Act of 1934, restructure the Bell system, and modify the 1956 AT&T antitrust consent decree. This legislation has a stated goal of increased deregulation and competition in telecommunications markets. S. 898, as currently drafted, however, will not serve this goal, but will have the undesirable effect of lessening or eliminating competition, stifling innovation and increasing the need for regulation. In short what S. 898 would do is permit AT&T entry into unregulated markets for computers and data processing without any meaningful safeguards for competition now serving those markets.

We do no seek protection of our markets, but equity. AT&T struck a bargain with the Department of Justice in 1956 which allowed them to remain vertically integrated with their manufacturing arm, Western Electric, and freed them from the prospect of multiple treble-damage awards in private cases in exchange for remaining forever confined to the realm of regulated communications services. Now AT&T seeks to broaden its horizons and giving up nothing and move into unregulated markets. Companies serving those unregulated markets today include many small to medium sized innovative companies which should not be stifled merely because AT&T is, 25 years later, unhappy with the terms of its bargain. AT&T is an unquestioned industrial giant with overwhelming monopoly power. Adequate safeguards must be provided for by deliberate and careful design to assure that these innovative companies will not be adversely impacted by AT&T's entry. We believe that this nation's technological advancement, economic performance and growth are contingent upon the future viability of the small to medium sized businesses which have created the new and exciting market segments of telecommunications, networking, time sharing, data processing, and word processing. These smaller companies have created these markets which AT&T would now like to enter and harvest.

CCIA's average member company has approximately $60 million revenue; AT&T has approximately $60 billion. AT&T has a long history of anticompetitive conduct and of using its monopoly revenues to cross-subsidize equipment and services encountering competition to the detriment of competitors. The smaller companies obviously are entitled to meaningful safeguards against any AT&T intrusion now into unregulated markets.

S. 898 does nothing to ensure against AT&T's incentive and opportunity to engage in anticompetitive practices particularly cross subsidization of new products and services provided by its controlled subsidiary.

Under S. 898 the so-called "fully separate" subsidiary would in no way be "fully" separated from its parent. Thus, the safeguard afforded to competition by this device would be minimal and inadequate. Substantial amounts of Congressional testimony, and studies by independent observers, support the conclusion that the intended separation is inadequate:

> In his September 9, 1980 testimony before the House Judiciary Committee Chairman Rodino's Subcommittee on Monopolies and Commercial Law on a very similar bill -- H.R. 6121, University of Pennsylvania law professor Louis Schwartz testified that the bill's "fully separated subsidiary is a fiction, a contradiction in terms, and an "ineffective safeguard,"
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> Former Assistant Secretary Geller, himself, told that Subcommittee that the "parent corporation fully controls the subsidiary. It is not meant to change, in any way, incentives."
>
> At the same hearing, former Attorney General Litvack observed that he had "grave doubts... about the ability ofa separate subsidiary to work even...to deal with cross-subsidy."
>
> Former Comptroller General Staats, by letter of September 5, 1980, advised Subcommittee Chairman Rodino that "if the parent firm has an incentive to excerise its market power to the disadvantage of consumers and competitors in the absence of a separate subsidiary, it has the same incentive to do so after the separate subsidiary has been required."
>
> Arthur D. Little, Inc., in a 1977 study of a regulated AT&T subsidiary for competitive services, concluded that the incentives for AT&T to behave anticompetitively would not be reduced and that the opportunities for such conduct would be diminished only marginally.

AT&T's conduct through separate subsidiaries can be assessed today by looking to AT&T's already existing separate subsidiaries: 17 of the 23 Bell Operating Companies, Western Electric, and

Bell Telephone Laboratories, are wholly owned by AT&T, each is a "separate subsidiary." Yet, AT&T is a defendant in a government antitrust suit and in more than 30 private suits, many of which allege anticompetitive practices conducted with and through those separate subsidiaries. This is also true with respect to a number of the private suits already settled, or decided against AT&T.

Of course, S. 898 would not really require use of a "fully separated" subsidiary in a meaningful sense of that term. AT&T's President, Williiam Ellinghaus, in an interview reported in Bell Telephone Magazine (Edition 6, 1980), stated, "We just want to make sure that, whatever the names, the entities will work in concert...to enhance the good of the corporation itself."

The subsidiary could engage in joint ventures and partnerships with its affiliated dominant carrier, and could also engage in joint advertising and joint use of property. In addition certain significant research, development, and manufacturing activities for customer premises equipment would never be really separated. Such "separation" as is prescribed would be inadequate on its face, and yet would take eight years to be accomplished. Last week, the CCIA filed its briefs before the U.S. Court of Appeals challenging the FCC's "separate" subsidiary concept for the same reasons.

Another fundamental defect in S. 898 and similar approaches is that they do not really serve their stated purpose, deregulation. S. 898 will substantially increase the complexity of Federal Communications Commission regulation, leaving it without effective authority to deal with the anticompetitive abuses inherent in AT&T's simultaneous participation in regulated and unregulated markets.

In its recent "Computer II" Decision, the FCC claimed jurisdiction over AT&T's provision, through its [illegible], of new customer premise equipment and enhanced services, including data processing, although no tariffing of these products or services would now be required. Even th[illegible] [illegible], as it stated in its Final Decision:

> "[I]n general, if the parent [illegible] exercise its market power t[illegible] to consumers and competitors in [illegible] of separate subsidiary, it has [illegible] to do so after one is requir[illegible]

The bill actually provides for substant[illegible] regulatory activity by the FCC. For exampl[illegible] [illegible]ovdes for a complicated series of regulatory [illegible] including regulated and non-regulated basic telecommunications service, non-basic telephone services, non-[illegible] telecommunications services, non-regulated carrie[illegible] carriers, and dominant regulated carriers (which [illegible] carriers in addition to AT&T). The Commission is give[illegible] wide discretion to include or exclude carriers and services from these classifications on a constantly changing basis. There are simply no bounds to the extensive regulatory powers which S. 898 reserves for the Commission.

I believe it important to recall why the Bell System is regulated the way it is today. Following the passage of

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1/ Amendment of Section 64.702 of the Commission's Rule and Regulations (Second Computer Inquiry), Docket 20828, May 2, 1980, at ¶204.

the Communications Act of 1934 and the establishment of the Federal Communications Commission (FCC) in 1935, Congress directed the Commission to investigate AT&T and the telephone industry as a whole. After a detailed inquiry into the telephone industry, the FCC presented its Final Report to Congress in 1939. The FCC found:

> The Bell System has consistently pursued the policy of obtaining control of a nation-wide unified telephone system. Since its [illegible] the watchword has been 'One System, One Policy, [illegible] Service.' In achieving its present dominant [illegible], the Bell System has been successful [illegible] elimination of effective competition. There [illegible] no competition worthy of the name from [illegible] standpoint, with the unified [illegible]
>
> In the manufacturing field [illegible] Co. sells approximately [illegible] telephone apparatus equipment, cable, [illegible] in the United States. The [illegible] is divided mainly among seven [illegible] manufacturers. As substantial portion of [illegible] equipment manufactured by independent [illegible] purchased by Western Electric Co. [illegible] associated companies.
>
> Attempts at this late date to [illegible] strong independent telephone system to compete with the Bell System would be futile. [illegible] of the rate-paying public by means [illegible] competition is now, and for a [illegible] been [illegible] be [illegible]

Direct government regulation of AT&T and telecommunications came from Congressional concern for a national telecommunications policy. The FCC was charged by Congress with the authority over the regulation of telecommunciations.

These findings by the FCC in 1939 show that government regulation of AT&T resulted from a recognition of AT&T's dominance and control over competition rather than from a recognition that the nature of telecommunications required a natural monopoly. Of course, we all know of the 1956 Consent

Decree and its present restrictions on the Bell System which AT&T then welcomed to avoid divestiture in the government's earlier antitrust lawsuit.

The 1956 Consent Decree, which embodies AT&T's agreement to remain confined to tariffed communications services and incidential services in exchange for continued monopoly power in communications, would be vitiated without any safeguards for such competition against AT&T's use of its monopoly power.

Moreover, legislation such as S. 898, that addresses the structure of the Bell System, would inevitably have a profound impact on present and prospective antitrust litigation, including U.S. v. AT&T, the antitrust case which was initiated by the Ford Administration in 1974. Indeed, William Saxbee, who was Attorney General at that time, has stated that legislation strikingly similar to S. 898 would "gut" the antitrust case. He is not, by any means, alone. At the same House Subcommittee hearings cited above, former Assistant Secretary Geller admitted that "whatever is done...by the Congress will be taken into account by the court." Former Assistant Attorney General Litvack stated that the Judge "has to consider changes that may be made by legislation...." And Professor Schwartz said that enactment of S. 898 "would be an antitrust disaster."

Assistant Attorney General Baxter, testifying before the Rodino Subcommittee at April 29 oversight hearings, stated that the enactment of such legislation would surely cause the Judge to question whether there was any basis on which he should order structural remedies different from those directed by the Congress. Sharing these antitrust concerns, we commend the Senate Chairman for seeking referral of S. 898 to this Committee.

Under all of these circumstances, legislation that would restructure the Bell System at this time can be fairly characterized as an attempt to exempt AT&T from the application of the federal antitrust laws, nothwithstanding the fact that it has been found and may, in the government's own case, again be found to have substantially violated those laws. Clearly, there is nothing in the record before the Congress to justify abandonment of the Justice Department's plea for divestiture before the Court (or the Congress) has considered the evidence in the antitrust case.

As cited in its Statement of Contentions, the government based its antitrust action against AT&T on the facts that:

> The defendants "have abused their position of dominance through a number of exclusionary and restrictive practices designed to preserve and extend their market power and monopoly position throughout the markets for telecommunications services and telecommunications equipment."
>
> "In order to deter potential competitors and eliminate actual competitors, AT&T has engaged in predatory pricing, refusal to supply transmission service, pre-selling, and other marketing and operational practices available to it as a monopoly supplier of long distance service."
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> "AT&T has also used its control over the 23 Bell operating companies and the power of their monopoly of local telephone service to deter would-be competitors in telecommunications."
>
> "The monopolies in long distance and local telecommunications services provided defendants with the means for both obtaining and then preserving their monopoly position in telecommunications equipment."

The new Assistant Attorney General in charge of the Antitrust Division, William Baxter, has reviewed the government's case carefully and has concluded that it is "perfectly sound" and should be pursued aggressively. If the government's charges are proven at trial, it will have established a number of clear cut violations of the Sherman Act and the court would be expected to order such remedies as may be required to stop further violations and permit fair competition to evolve in the marketplace.

Unleashed without proper and adequate safeguards for competition in the unregulated markets, the Bell System will extend its monopolistic tentacles through the "separate" subsidiary and stifle the forces of competition in the new markets to serve its own corporate policies and purposes.

Rather than make S. 898 law, a deliberate and effective national telecommunications policy must be fashioned, one that would facilitate competition and deregulation without jeopardy to the small and medium-sized companies which have pioneered the new markets AT&T would like to exploit.

We believe that an effective approach to a sound national telecommunications policy exists. If there is complete and total seperation between the monopoly basic telecommunications service company and the competitive product and service company, most of the fears, and with them most of the opposition to legislation, will vanish. Those who have urged continuation of the pending litigation have done so because they sincerely believe that only through a court judgment was it likely that the underlying cross-benefits accruing from the monopoly company to the competitive company would be dealt with once and for all.

During the course of the policy debate that has taken place during the past five years, only fleeting consideration has been given to divestiture as a solution to the problems that I have discussed because many believe that divestiture implies punishment and represents a "taking away of property."

We believe that a workable long term solution is feasible. First, however, we must recognize that AT&T does not belong to the management of the company, it belongs to the company's three million shareholders. Most acquired the stock because of its risk free nature, stability and assured rate of return.

Under current proposals these shareholders are faced with forced participation in a high-risk, no guaranteed return enterprise. We believe that AT&T's shareholders should have the option of participating in the regulated business, the competitive business, or both.

We believe that Congress should enact legislation directing the management of AT&T, if it wishes to participate in unregulated markets, to divide its assets, liabilities, facilities, and personnel in order to manage and operate the basic regulated transmission system on the one hand, and to research, develop, manufacture, market, and service competitive products and services on the other. Each AT&T shareholder would be issued shares reflecting their pro rata ownership of each company. Under this proposal:

1. No shareholder incurs any losses or tax consequences, to the contrary the shares of the competitive entity would enjoy a price/earnings ratio in the 20 to 30 range -- like CCIA's member companies -- rather than AT&T's price/earnings ratio of 6 to 7.
2. The new competitive corporation would be free of the restrictions of the 1956 Consent Decree.

3. The basic network company would have every incentive to modernize and expand the network and encourage diversified utilization of that network on a nondiscriminatory basis.

4. The competitive corporation would pay full corporate taxes and be subject to shareholder and SEC oversight rather than FCC regulation.

5. The financial markets would set the value of each company based upon the ability of its management and the success of their endeavors.

6. The portion of Bell Labs that remains with the monopoly telecommunications company would be devoted to the needs of the network and would have every incentive to make the fruits of its research available to all.

7. There would be absolute certainty, without burdensome controls, that no ratepayer would bear the cost of participation in competitive product and services markets.

8. The regulatory burden, ongoing litigation, and delays in the introduction of new products and services would be vastly reduced.

This solution, achieves public policy, harms no one, brings an end to the long drawnout debates, and lets us all get on with the business of innovating, creating new jobs, and contributing to our nation's balance of trade.

APPENDIX TO STATEMENT OF A. G. W. BIDDLE

I. The Existence of The 1956 AT&T Consent Decree Invokes Special Legal and Policy Considerations, Not Applicable to Other Carriers, Regarding AT&T's Activities in Unregulated Markets, and in the Provision of Non-Communications Equipment and Services. As a Settlement of Major Antitrust Litigation, the Decree Carries Special Significance Relating to Antitrust Law and Anti-Competitive Behavior; the Congress Should Take This Into Account in Fashioning Related Public Policy.

The 1956 AT&T Consent Decree[1] represents the settlement of a major antitrust prosecution instituted by the Government seven years earlier. Approximately three fourths of the antitrust actions filed by the Justice Department have resulted in consent decrees, and thus such decrees have become a major vehicle, if not the major vehicle, for administration of the antitrust laws. The AT&T Consent Decree is one of the most important in existence today. To the extent that such decrees are nullified by non-judicial action, the Justice Department is deprived of a primary tool for achieving the objectives of the antitrust laws, and effective enforcement will require a much greater degree of protracted and costly litigation.

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[1] United States v. Western Electric Co., 1956 Trade Cas. Para. 68,246 (D. N.J. 1956) (hereafter, the AT&T Consent Decree).

In consenting to this judgment, AT&T achieved several extremely important objectives. Perhaps the most important, in its view, was the preservation of the vertically integrated structure of the Bell System, which it has retained for the intervening 24 years.[1] Second, it avoided the possibility of a litigated decree, which could be used as prima facie evidence in private antitrust suits.[2] AT&T preferred these protections even to a dismissal without prejudice.[3]

In return for what it gained, AT&T agreed to confine its activities (and market power) to the business of regulated common carrier communications services, and Western Electric (which was in the communications manufacturing business and not, therefore, engaging in regulated common carrier services) to the manufacture of equipment used in furnishing regulated common carrier communication services.[4]

The Supreme Court has imposed a stringent test on the modification of antitrust consent decrees. The policy underlying this test reflects the great importance the Court has attached to consent decrees in view of their antitrust context, and of their role in preserving competition. Defendants are not easily permitted to regain what they have given up in order to avoid a litigated judgment. Accordingly, the mere fact that a decree places a defendant in an unfavorable competitive position has invariably been rejected as an inadequate ground for modification.[5]

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[1] Antitrust Subcomm. of the House Comm. on the Judiciary, 86th Cong., 1st Sess., Report on the Consent Decree Program of the Department of Justice, at 96 (hereafter, 1959 Judiciary Report).

[2] Clayton Act Sec. 5(a), 15 U.S.C. Sec. 16(a).

[3] 1959 Judiciary Report at 90.

[4] AT&T Consent Decree, Sections V and IV respectively.

[5] See, e.g., cases cited in Kelly, Construction and Modification of Antitrust Consent Decrees; New Approaches After the Antitrust Procedures and Penalties Act of 1974, 77 Col. L. Rev. 296, 306 n. 94 (1977).

rejecting modification of the now famous Meat Packers Consent Decree are directly applicable:

> It has been said that the decree itself offends the policies of the antitrust laws since it restrains lawful competition by the defendants. The point illustrates one of the many paradoxes of the Sherman Act, that it is sometimes necessary to restrict competition in order to preserve it. The elimination of three or four potential competitors from the general . . . industry can hardly be said to harm the public interest, and to whatever extent the defendants would be a significant competitive power in the field, the fears which gave birth to the decree are confirmed.
>
> . . . .
>
> In the typical case, it might be safe to presume that after forty years the object of the equity decree will have been achieved if it ever is to be. . . . Here the defendants were huge and remained huge after the decree. They chose to retain size . . . rather than to risk further dismemberment, at the price of abandoning the opportunity to extend into other fields. The decree therefore operates as a restraint and a fetter to preserve the balance of competitive power. Its usefulness is not exhausted or outworn so long as the petitioners retain the economic might they attained through the combination. [1]

The AT&T Consent Decree raises crucial and legitimate issues relating to the antitrust laws, anti-competitive behavior, and industry structure in the computer and communications industries. Accordingly, the legal criteria for judicial modification of such decrees, as well as the true significance of the AT&T Decree in the antitrust context, should be fully taken into account by the Congress in considering any possible modification of this important decree.

II. The Record Underlying S. 898 and Its Predecessor Bills Is Clearly Insufficient to Support Modification of the AT&T Consent Decree Under the Legal Standards Applicable to Judicial Modification.

The general test for the judicial modification of antitrust consent decrees has been set out by the Supreme Court in United States v. Swift & Co.:

> The inquiry [to be made] is whether the changes are so important that dangers once substantial, have

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[1] United States v. Swift & Co., 189 F.Supp. 885, 912 (N.D.Ill. 1960), aff'd per curiam, 367 U.S. 909 (1961).

> become attenuated to a shadow. No doubt the defendants will be better off if the injunction is relaxed. . . . Nothing less than a clear showing of grievous wrong evoked by new and unforeseen conditions should lead us to change what was decreed after years of litigation and with the consent of all concerned. [1], [2]

The doctrine of Swift has retained its vitality.[3] In applying the standard of Swift to proposed modifications, the courts look beyond the decree itself to the underlying litigation and the purposes of that litigation. In the words of the Supreme Court:

> Swift . . . holds that [a decree] may not be changed in the interests of the defendants if the purposes of the litigation as incorporated in the decree (elimination of monopoly and restrictive practices) have not been fully achieved. [4]

The major relief requested in the litigation underlying the 1956 Decree was, of course, the divestiture of Western Electric from AT&T and the dissolution of Western into three competing manufacturing concerns;[5] the primary purpose of the litigation was to eliminate Western's monopoly in the manufacture and provision of telecommunications equipment. The Government's Complaint specifically alleged that AT&T's monopoly in communications services allowed it to confer a monopoly on Western Electric in the market for related equipment.

The specific inquiry to be made under Swift requires an analysis of any changes in AT&T's market power and dominance (the original "need" for the decree), as well as the anti-competitive potential of a vertically integrated Bell System acting in competitive markets.

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[1] 286 U.S. 106, 119 (1932) (hereafter, Swift).

[2] The legal standard for modification of the AT&T Consent Decree has been discussed in the filings of parties to the FCC's "Second Computer Inquiry" (Amendment of Section 64.702 of the Commission's Rules and Regulations, pending in Docket 20828). In that proceeding both parties to the Decree, the Department of Justice and AT&T, have cited Swift as the standard applicable to judicial modification. (E.g., Initial Comments of the United States Department of Justice at 48, [Initial] Comments of AT&T at 99.)

[3] United States v. Swift and Co., 189 F.Supp. at 901. See generally, Flexibility and Finality in Antitrust Consent Decrees, 80 Har. L. Rev. 1303 (1967).

[4] United States v. United Shoe Machinery Corp., 391 U.S. 244, 248 (1968) (emphasis in orginal).

[5] 1959 Judiciary Report at 33.

The Government's expert agency with respect to antitrust matters, the Justice Department, clearly does not believe that the anti-competitive dangers relating to AT&T have been attenuated; to the contrary, it has stated that neither AT&T's structure nor market dominance has significantly changed since the writing of the Decree.[1/] It is again seeking divestiture of Western Electric in its present antitrust suit against AT&T, and has described AT&T's anti-competitive abuses of its vertically integrated structure in great detail in a recently filed 2,000 page document in that suit.[2/] Indeed, even if it were so inclined, the Justice Department cannot acquiesce in a modification of the Decree which allows AT&T entry into new unregulated markets on a vertically integrated basis without contradicting its own position in the current AT&T antitrust suit.

The Swift standard has not been met in the record underlying S. 898 and its predecessor bills. Even if an attempt were met, it is unlikely that AT&T or other proponents of modification could demonstrate attenuation of the anti-competitive dangers underlying the Decree (in view of AT&T's present market power and vertically integrated structure), oppressive hardship (in view of AT&T's revenues and profitability), or unforeseeability of changed industry circumstances[3/] sufficient to meet the standards for modification required by Swift.

III. The Congress Should Either Adhere to the Legal Standards for Judicial Modification of the Decree, or Clearly State the Public Policy Grounds for the Waiver of Such Judicial Precedent Solely in the Case of AT&T.

As just described, the Swift standard for modification of antitrust consent decrees requires the anti-competitive dangers which

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[1/] FCC Second Computer Inquiry, Initial Comments of the United States Department of Justice at 50, 55, supra p. 4 n. 2.

[2/] United States v. AT&T, No. 74-1698 (D.D.C.), Complaint (filed Nov. 20, 1974) and Plaintiff's Third Statement of Contentions and Proof (filed Jan. 10, 1980).

[3/] It is plainly evident that AT&T was aware of the emergence of the data processing field as early as 1955, and that it fully understood that the Decree would confine its activities to the business of communications common carriage. See e.g., Antitrust Subcommittee of the House Committee on the Judiciary, 85th Cong., 2d Sess., Hearings on the Consent Decree Program of the Department of Justice, Part II, Vol. III, App. IV, at 4115; Part II, Vol. II at 2423-24.

existed at the time of the decree to have become attenuated "to a shadow," extreme hardship on the defendant (AT&T), and a lack of foreseeability of changed industry circumstances. Swift requires a "clear showing" of these elements; there is no question that "petitioners . . . bear the burden of proof on their petitions, and their burden is heavy."[1/]

The Congress would be remiss in its responsibilites if it modified the AT&T Consent Decree without directly addressing and meeting the legal standards for judicial modification, or specifically presenting sound public policy grounds for legislatively waiving such antitrust precedent solely in the case of AT&T. Neither the showing required for modification in accordance with judicial precedent, nor the affirmative case for waiver of judicial precedent, has been presented by the proponents of modification; the Congress should not be asked to modify the Decree, entered into by the Government on behalf of the public, in the absense of such argument on the merits.

1/ United States v. Swift & Co., 89 F.Supp. at 906. See 80 Har. L. Rev. at 1311.

PREPARED STATEMENT OF PETER F. ERB

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, MY NAME IS PETER ERB. I AM THE PRESIDENT AND CHIEF EXECUTIVE OFFICER OF MILLICOM INCORPORATED. MILLICOM SUPPORTS YOUR EFFORTS TO EXAMINE THE DEGREE OF MONOPOLIZATION AND COMPETITION IN THE TELECOMMUNICATIONS INDUSTRY. I APPRECIATE THE OPPORTUNITY TO PARTICIPATE IN THESE HEARINGS, AND HOPE THAT MY TESTIMONY WILL HELP YOU TO BETTER UNDERSTAND THE TELECOMMUNICATIONS INDUSTRY AS IT EXISTS TODAY AND AS IT IS LIKELY TO EXIST IN THE FUTURE.

IT IS MY UNDERSTANDING THAT THE PRIMARY PURPOSE OF TODAY'S HEARING IS TO GIVE THE MEMBERS OF THIS COMMITTEE AN OVERVIEW OF THE STRUCTURE OF THE COMMUNICATIONS INDUSTRY. THEREFORE, MY REMARKS WILL BE LIMITED TO EXPLAINING MILLICOM'S INVOLVEMENT WITH A NEW FORM OF COMMUNICATIONS TECHNOLOGY CALLED CELLULAR RADIO. I WILL ALSO EXPLAIN HOW THE FCC

PROPOSES TO REGULATE THIS NEW SERVICE, AND WHY MILLICOM IS OPPOSED TO THE COMMISSION'S REGULATORY APPROACH.

MILLICOM WAS FORMED ABOUT TWO YEARS AGO FOR THE PURPOSE OF DEVELOPING AND MARKETING--AS A COMPETITIVE ALTERNATIVE TO SOME OF THE EXISTING SERVICES OF THE TELEPHONE INDUSTRY--A LOW COST TELEPHONE SERVICE UTILIZING CELLULAR TECHNOLOGY AND ADVANCED COMPUTER SWITCHING TECHNIQUES.

CELLULAR TECHNOLOGY INVOLVES THE USE OF AN INTERCONNECTED ARRAY OF RADIO TRANSMITTING AND RECEIVING SITES IN VARIOUS GEOGRAPHIC AREAS, CALLED CELLS. MESSAGES ARE ORIGINATED AND RECEIVED BY SMALL RADIO TRANSCEIVERS WHICH SERVE AS THE EQUIVALENT OF TRADITIONAL TELEPHONE HANDSETS.

CELLULAR RADIO COMMUNICATION IS UNLIKE TRADITIONAL WIRELINE NETWORK TELEPHONE SERVICE IN THAT IT PERMITS MOBILITY AND GREATER FLEXIBILITY TO SATISFY CHANGING SUBSCRIBER REQUIREMENTS. AS COMPARED TO CONVENTIONAL TWO-WAY RADIO SERVICES (*E.G.*, CAR TELEPHONES), CELLULAR TECHNOLOGY CAN PROVIDE SERVICE TO A FAR GREATER NUMBER OF SUBSCRIBERS THROUGHOUT A MUCH LARGER GEOGRAPHIC AREA. CELLULAR SYSTEMS ALSO AVOID THE PROBLEMS OF "FADE OUT" AS THE USER MOVES AWAY FROM THE TRANSMITTER, AND SIGNAL BLOCKAGE BY LARGE STRUCTURES. THESE PROBLEMS PLAGUE TRADITIONAL MOBILE TELEPHONE SYSTEMS WHICH DEPEND ON A SINGLE TRANSMITTER.

CELLULAR SUBSCRIBERS CAN COMMUNICATE WITH EACH OTHER, THROUGH WIRE AND RADIO LINKS BETWEEN CELLS, AND WITH CONVENTIONAL TELEPHONES THROUGH INTERCONNECTION WITH THE WIRE TELEPHONE NETWORK.

MILLICOM'S APPROACH TO CELLULAR COMMUNICATIONS IS COMPLETELY DIFFERENT FROM THAT ENVISIONED BY AT&T AND OTHER POTENTIAL CELLULAR COMPETITORS. MILLICOM IS DEVELOPING A PORTABLE, HAND-HELD TELEPHONE DESIGNED AND PRICED TO BE

ATTRACTIVE AND AFFORDABLE TO THE GENERAL PUBLIC FOR HOME, OFFICE, AUTO, AND TRANSIENT USE. THE MILLICOM UNIT WILL BE CAPABLE OF QUALITY VOICE AND DATA TRANSMISSION AND RECEPTION.

UNLIKE THE BULKY UNITS NOW IN OPERATION OR CONTEMPLATED BY OTHER MANUFACTURERS, THE MILLICOM PORTABLE TELEPHONE WILL WEIGH JUST ONE POUND. OTHER CELLULAR RADIOTELEPHONE SYSTEMS ARE BEING DESIGNED TO PROVIDE A MUCH MORE LIMITED RANGE OF VEHICULAR COMMUNICATIONS SERVICES TO A SMALL SECTOR OF SOCIETY, COMPRISED OF BUSINESS AND PROFESSIONAL SUBSCRIBERS. MILLICOM BELIEVES THAT ITS APPROACH WILL EVENTUALLY PERMIT CELLULAR TECHNOLOGY TO PROVIDE THE BASIS FOR THE DEVELOPMENT OF AN ALTERNATIVE TO THE EXISTING MONOPOLISTIC CONTROL OF LOCAL DISTRIBUTION BY AT&T.

CURRENTLY, THE WIRELINE TELEPHONE COMPANIES CONTROL VIRTUALLY ALL LOCAL TELEPHONE DISTRIBUTION FACILITIES. THESE LOCAL DISTRIBUTION FACILITIES ARE CALLED EXCHANGES. SPECIALIZED LONG DISTANCE CARRIERS SUCH AS SOUTHERN PACIFIC AND MCI ARE DEPENDENT ON BELL OPERATING COMPANIES FOR THE LOCAL INITIATION AND TERMINATION OF CALLS. AT&T, BECAUSE OF ITS CONTROL OF THE BELL OPERATING COMPANIES, STANDS BETWEEN ITS COMPETITORS' LONG DISTANCE SERVICES AND THEIR CUSTOMERS. CELLULAR RADIO, WHEN FULLY DEVELOPED, COULD EVENTUALLY REPLACE OR SERVE AS AN ALTERNATIVE LOCAL EXCHANGE FACILITY. IT MUST BE RECOGNIZED, HOWEVER, THAT CELLULAR TECHNOLOGY IS NOW IN ITS INFANCY, MUCH LIKE THE COMPUTER INDUSTRY WAS IN THE 1950'S. THUS, MILLICOM BELIEVES THAT, TO THE EXTENT REGULATION OF THIS SERVICE IS NECESSARY, IT SHOULD FOSTER THE GROWTH OF CELLULAR RADIO INTO A FULL-FLEDGED ALTERNATIVE TO THE PRESENT LOCAL EXCHANGE BOTTLENECK.

THE FEDERAL COMMUNICATIONS COMMISSION HAS BEEN LOOKING AT THE CELLULAR AREA FOR A NUMBER OF YEARS. MILLICOM

URGED THE COMMISSION TO ADOPT A COMPETITIVE, OPEN ENTRY MARKET STRUCTURE FOR CELLULAR RADIO COMMUNICATIONS SERVICES. UNDER THIS APPROACH, ANY TECHNICALLY AND FINANCIALLY QUALIFIED PROSPECTIVE SUPPLIER OF CELLULAR SERVICE WOULD BE GRANTED A LICENSE FOR NONEXCLUSIVE SHARED USE OF ALL CELLULAR RADIO CHANNELS TO BE ALLOCATED TO THIS SERVICE. THE DEPARTMENT OF JUSTICE SUPPORTED THIS OPEN ENTRY APPROACH IN COMMENTS FILED IN THE COMMISSION'S CELLULAR PROCEEDING (CC DOCKET 79-318).

UNFORTUNATELY, THE COMMISSION REJECTED MILLICOM'S SUGGESTION AND ADOPTED INSTEAD AN APPROACH WHICH GIVES AT&T AN EXCLUSIVE ALLOCATION OF ONE-HALF THE AVAILABLE SPECTRUM AND FORCES NONWIRELINE COMPETITORS INTO LENGTHY AND EXPENSIVE COMPARATIVE HEARINGS. THUS, IF THE DECISION IS UPHELD, COMPANIES LIKE MILLICOM ARE LIKELY TO BE TIED-UP IN COMPARATIVE HEARINGS FOR YEARS, WHILE AT&T BENEFITS FROM A REGULATORY HEAD START.

MILLICOM BELIEVES THAT IT IS INEQUITABLE TO GRANT AN EXCLUSIVE SPECTRUM ALLOCATION TO AT&T. IN REPLY COMMENTS FILED IN THE COMMISSION'S CELLULAR PROCEEDING, THE DEPARTMENT OF JUSTICE STATED:

> [I]T WOULD BE BLATANTLY ANTICOMPETITIVE FOR THE COMMISSION TO AUTOMATICALLY ASSIGN ONE LICENSE IN A TWO CARRIER CELLULAR MARKET TO THE LOCAL WIRELINE TELEPHONE COMPANY. NO REASON EXISTS WHY WIRELINE CARRIERS SHOULD BE GIVEN THIS PREFERENTIAL POSITION.[1]

GRANTING AT&T A COMPETITIVE ADVANTAGE IN PROVIDING CELLULAR SERVICE IS CONTRARY TO THE PUBLIC INTEREST. THIS ASSERTION IS BASED ON THE FACT THAT AT&T HAS EVERY INCENTIVE TO RETARD, RATHER THAN PROMOTE, THE FULL DEVELOPMENT OF

CELLULAR SERVICE SINCE SUCH ACTIONS COULD THREATEN ITS ENORMOUS INVESTMENT IN THE FIXED LANDLINE TELEPHONE SYSTEM.

IN VIEW OF HOUSE AND SENATE EFFORTS TO RESTRUCTURE THE TELECOMMUNICATIONS INDUSTRY, MILLICOM BELIEVES THAT CELLULAR TECHNOLOGY MERITS CONGRESSIONAL ATTENTION. PERMITTED TO DEVELOP TO ITS FULL POTENTIAL, CELLULAR RADIO OFFERS AN ALTERNATIVE TO AT&T'S LOCAL DISTRIBUTION MONOPOLY. HOWEVER, IF THOSE WHO HAVE THE INCENTIVE TO DEVELOP AND MARKET THE NEW TECHNOLOGY ARE HANDICAPPED BY REGULATORY RESTRAINTS, CELLULAR RADIO MAY NEVER BE FULLY DEVELOPED.

THANK YOU FOR PERMITTING ME TO TESTIFY ON BEHALF OF MILLICOM TODAY.

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1. Reply Comments of the Department of Justice, FCC CC Docket No. 79-318, July 3, 1980, p.4.

Senator SPECTER. There are a number of questions which have been prepared by the staff for submission to you. We will submit those to you in writing.

If there is anything further that you want to communicate to the committee, please do so.

By way of further elaboration, for anyone who does not understand the bell system, which realistically includes me, when one bell rings it means there is a vote and there is 15 minutes. When the board lights up, it means half the time is gone.

That is the reason that I have abbreviated the session as I have. I now have about 6 minutes to get there to vote, which I can do.

That is the first responsibility of all of us in the Senate.

It has been quite a hectic afternoon there so far, and I think it highly likely that I would be unable to get back. However, I think we do have the highlights of your testimony, and we thank you all very much.

The hearing is adjourned.

[Whereupon, at 4:25 p.m., the hearing adjourned, to reconvene subject to call of the Chair.]

MONOPOLIZATION AND COMPETITION IN THE TELECOMMUNICATIONS INDUSTRY

THURSDAY, JULY 23, 1981

U.S. SENATE,
COMMITTEE ON THE JUDICIARY,
Washington, D.C.

The committee met, pursuant to recess, at 1 p.m., in room 2228, Dirksen Senate Office Building, Senator Arlen Specter (acting chairman of the committee), presiding.

Also present: Senators Thurmond, Baucus, and Grassley.

Staff present: Marcy J. K. Tiffany, antitrust counsel and chief economist; Stephen Cannon, antitrust counsel.

OPENING STATEMENT OF SENATOR ARLEN SPECTER

Senator SPECTER [acting chairman]. This hearing will begin, ladies and gentlemen.

This is the third in a series of hearings on monopolization and competition in the telecommunications industry being conducted by the full Senate Committee on the Judiciary.

At our last hearing, we reviewed the background and structure of the many diverse markets which together constitute the telecommunications industry. Today, we will focus on specific anticompetitive problems that exist in the industry and how the competitive structure of its various component markets might be affected by S. 898, the Telecommunications and Deregulation Act.

We are very pleased and express our appreciation for the industry representatives and economists who have agreed to testify here today and share their perspectives with us.

I do want to express disappointment and note that no spokesman from A.T. & T. could be with us this afternoon, but I understand that A.T. & T. will be offering testimony as these hearings continue.

At this time, I am pleased to welcome the first panel: Mr. Harold E. O'Kelley, president and chief executive officer of Datapoint Corp., and Mr. William G. McGowan, chairman of the board of MCI Corp.

Mr. O'Kelley, we thank you for coming here today. We have received your statement in advance. It will be made a part of the record of the committee following your oral presentation. The procedures which we follow are to ask that you summarize the highlights of your statement, which will leave us as much time as possible for questions and answers.

STATEMENT OF HAROLD E. O'KELLEY, PRESIDENT, CHIEF EXECUTIVE OFFICER AND CHAIRMAN, DATAPOINT CORP., SAN ANTONIO, TEX., ACCOMPANIED BY JACK MENACHE, VICE PRESIDENT, LEGAL, DATAPOINT CORP.

Mr. O'Kelley. Thank you, Senator.

Relative to the material that we have submitted, I would point out to the Senator there is one minor error in it. We cited an 8-year transition period in the written submission. It should have been a 6-year transition period. I apologize for the error.

I would also like to introduce Mr. Jack Menache, sitting on my left, who is our vice president of legal at Datapoint Corp.

Datapoint Corp. is a public corporation founded in 1968 and has become a leading manufacturer of data processing and telecommunication equipment with revenues of approximately $400 million a year and approximately 6,500 employees. Datapoint exports approximately 40 percent of the product it manufactures.

Senate bill 898 should be revised to provide for the division of A.T. & T. into at least two publicly traded corporations: Western Electric on the one hand, and A.T. & T., which would include the operating companies, Bell Laboratory, and Long Lines.

Western Electric should be immediately divested and deregulated. A.T. & T. should remain regulated. Further, consideration should be given to divesting Long Lines into a separately owned corporation and gradually deregulate it as viable competition develops.

The method proposed above accomplishes complete deregulation of Western Electric without subjecting competitive markets to demonstrable anticompetitive dangers from A.T. & T.'s monopoly power. It facilitates gradual deregulation of the interstate telecommunications market as meaningful competition is introduced and permits continued State regulation of local telecommunications service.

Under S. 898, not only will A.T. & T. have the incentive to offer anticompetitive assistance to its affiliate, it will also have the opportunity both during and after the 6-year transition period. S. 898 relies on accounting controls for safeguards. In our judgment, they will not work.

It must be recognized that whatever the desire of the proponents of S. 898 to create a stand-alone competitive affiliate, the goal of the entire Bell system, from upper management to the telephone account executive, will be to lend assistance to the competitive affiliate to assure its success and to operate the entire A.T. & T. family profitably on an overall basis. S. 898 expressly authorizes A.T. & T. to manage and direct the affairs of its subsidiaries to the benefit of A.T. & T.

S. 898 is a prescription for stagnation in the telecommunications marketplace. A.T. & T.'s low level of innovation results primarily from its commercial desire to protect its installed equipment base. Bringing forth new and innovative products as a means of meeting competition is a risky undertaking. A much less risky means of meeting competition is to underprice an existing product line to encourage consumers to keep outdated, underpriced equipment.

An A.T. & T. affiliate, however, would possess by reason of its association with the A.T. & T. monopoly, access to monopoly revenues as a means of underpricing and defeating competition in any market that they wish to enter. Of course such a lower cost option for the consumer would be available only until competition was eliminated.

Mr. Chairman, that is the summary of my testimony.

DIVESTITURE OF WESTERN ELECTRIC AND LONG LINES IS APPROPRIATE

Senator SPECTER. You are suggesting, Mr. O'Kelley, dividing A.T. & T. into two companies or three companies?

Mr. O'KELLEY. From our viewpoint, that is the position of Datapoint serving the data processing and telecommunications equipment market, we believe that division into two companies is the appropriate one, but there are reasons that one might consider a third separation, that being Long Lines. I am advocating primarily the divestiture of Western Electric.

Senator SPECTER. Your suggestion as to Western Electric would be that there be deregulation, but not deregulation as to the other company?

Mr. O'KELLEY. That is correct. That is my position.

Senator SPECTER. So that the unregulated company would be subject to the same regulatory process which exists at the present time?

Mr. O'KELLEY. I am not sure I understand your question, Senator. Western Electric, which I suggest on a divested basis be unregulated, would be regulated by free and fair competition of the marketplace, but I do not think that the Government would have to provide any regulation beyond what it does to companies like our own.

Senator SPECTER. All right, but aside from the portion of Western Electric, the balance would then be subject to governmental regulation according to your suggestion?

Mr. O'KELLEY. Yes, sir, because I believe in the case of the Bell operating companies, they would still have exclusive franchise or monopoly, and I think regulation of rates would be necessary. In the case of Long Lines, I think regulation in the near term is necessary because in many areas there is no competition. That is, over many routes there is no competition.

Senator SPECTER. Is there competition on some routes?

Mr. O'KELLEY. Yes, sir. I think Mr. McGowan can tell you which they are better than I can.

Senator SPECTER. As to those routes, is it your view that there ought to be a governmental regulation even though there is competition there?

Mr. O'KELLEY. No, sir. My view would be if the competition is viable, those routes should be deregulated and let the marketplace establish the prices.

Senator SPECTER. What standard would you then apply to regulation or deregulation of Long Lines? How would you determine where the competition was sufficient to eliminate the necessity for governmental regulation on that specific Long Line?

Mr. O'KELLEY. I would delegate to the FCC the authority to make the determination where the competition on a specific route is viable. Let them make the decision as to which routes should be deregulated.

Senator **Specter**. Is there any intermediate step that you would think acceptable, or any safeguards that might be added to the legislation if legislation is to be enacted on total deregulation?

Mr. O'**Kelley**. On total deregulation of even the local Bell operating companies?

Senator **Specter**. Yes.

Mr. O'**Kelley**. Senator, in my judgment, I think that deregulating a service in an exclusively franchised geographic area, like an operating company area, is not feasible because rates then would be determined only by the monopoly that is serving that exclusive area.

ENACTMENT OF S. 898 WILL GIVE UNFAIR ADVANTAGES TO A.T. & T.

Senator **Specter**. Mr. O'Kelley, in what ways are you concerned that Datapoint Corporation will be specifically injured if the legislation is enacted in its current form?

Mr. O'**Kelley**. If S. 898 is enacted in its current form, the potential for a cross-subsidy of the unregulated equipment manufacturing portion of the business giving unfair advantage in manufacturing costs, in product development costs, and in marketing costs is likely to create lower prices than a stand-alone organization can achieve.

Therefore, we are likely to be hurt from the standpoint of our equipment sales in telecommunications and in data processing, which the A.T. & T. system has indicated they wish to enter. If they are able to enter on a cross-subsidized basis, they will have unfair advantage in the free unregulated business.

Senator **Specter**. Is that cross-subsidy not possible as to Western Electric, or do you think there will be a sufficient safeguard there if Western Electric is a totally separate corporation?

Mr. O'**Kelley**. If Western Electric was a totally separate corporation and had separate owners, there would be no motivation whatsoever for cross-subsidy. The independent management of Western Electric in that instance would serve in such a way or act in such a way as to benefit their shareholders, which would be a different set of shareholders.

Therefore, there would not be any motivation for cross-subsidy. In my judgment, what would transpire is that the Western Electric management, on a divested basis, would optimize the performance of the divested company to its benefit and to its independent shareholders' benefit.

Senator **Specter**. Let the record show that Senator Baucus, the distinguished Senator from Montana, has joined us. Welcome. Do you have an opening statement which you would care to make, Senator?

Senator **Baucus**. Thank you, Mr. Chairman. I am just here to learn.

Senator **Specter**. Mr. O'Kelley, would there be ample safeguards if A.T. & T. were compelled to form an independent subsidiary for data processing, which would follow along the same line that you have suggested as to Western Electric, which would prevent the cross-subsidy which concerns you as to unfair competition with your own company?

Mr. O'KELLEY. Senator, was your question would it be adequate if they formed a subsidiary?

Senator SPECTER. An independent subsidiary.

Mr. O'KELLEY. To me, Senator, it is not possible to form an independent subsidiary. A subsidiary company that is owned by a parent does what its parent tells it to do. To me, the term subsidiary means that that company is at least 80 percent owned by the parent. Generally, it is 100 percent owned.

Senator SPECTER. Suppose we took the next step and intead of having a subsidiary relationship or a brother-sister relationship, we required an independent corporation be formed?

Mr. O'KELLEY. If A.T. & T. were to spin off an organization that had separate ownership and separate independent management and that new organization entered the data processing business, that would be a good solution.

Senator SPECTER. How many separate components are there in the A.T. & T. operation which would have to be comprehended by separate corporations if we were to follow that route?

Mr. O'KELLEY. When you defined or suggested the separation of a data processing company from Western Electric, it seems to me you were suggesting that we may separate on the basis of markets. I am not sure what markets they wish to enter, Senator. I am not sure I am prepared to answer that.

I believe a better solution is to separate on the basis of combining the design engineering, manufacturing, and selling of equipment into a single corporation. That is the reason I suggest Western Electric be divested.

Senator SPECTER. If Western Electric is divested, would that satisfy the immediate concerns which Datapoint has?

Mr. O'KELLEY. Yes, sir.

Senator SPECTER. As far as Datapoint is concerned, it would not be of interest to you whether the balance of A.T. & T. were regulated or not? You are offering your testimony not from a concern about unfair competition but just from a general public-spirited citizen approach?

Mr. O'KELLEY. Yes, sir. My comments relative to regulation of the operating companies and Long Lines affect my company only in the rates that we will have to pay for telephone service. I make those comments principally in the interests of the country. I think we need to have a good telecommunications network, but I do not believe that where a monopoly exists that they can establish their rates unilaterially without Government control.

Senator SPECTER. Thank you very much, Mr. O'Kelley.

We will now turn to Mr. William G. McGowan, chairman of the board of MCI Corp. Welcome, Mr. McGowan.

STATEMENT OF WILLIAM G. McGOWAN, CHAIRMAN OF THE BOARD, MCI COMMUNICATIONS CORP., WASHINGTON, D.C.

Mr. McGOWAN. Thank you, Mr. Chairman

I will summarize my testimony today and request that my written testimony be included in the record with its appendixes.

Senator SPECTER. Mr. McGowan, your entire statement will be included in the record. As I said to Mr. O'Kelley, that will be made fully a part of the record following the oral presentation. We appreciate your summarization and leaving more time for questions.

Mr. MCGOWAN. Thank you.

MCI has had long and bitter experience with A.T. & T., the Bell system, and because of events now transpiring in this Congress, we are likely to have much more of the same. I believe A.T. & T. is marshaling political power behind its demonstrated intent not to compete fairly in a free market.

MCI is a small company relative to the telecommunications market with revenues last year of $234 million. We had approximately 1 percent of the long distance market. We compete directly with A.T. & T. in the provision of long distance telephone service.

MCI now has about 400,000 customers. The business customers range from the Fortune 500 companies to thousands of small businesses. However, most of our customers, well above 300,000, are residential consumers who use our network as a less expensive alternative to the Bell System for ordinary long distance telephone calls.

Senator SPECTER. Where do you operate geographically, Mr. McGowan?

Mr. MCGOWAN. Today, we operate in approximately 36 States and approximately 125 metropolitan areas that serve about 4,000 cities.

Senator SPECTER. All over the United States?

Mr. MCGOWAN. In 36 States. We are expanding continually. This year we are expanding about 60 percent. We only started our expansion several years ago when we were free to expand after Bell failed in stopping us from providing the service. Expansion has been ongoing since then.

Senator SPECTER. When you say Bell failed in stopping you from providing the service, what do you mean by that?

Mr. MCGOWAN. Bell tried to have the Commission and the courts rule that we were not authorized to provide long distance telephone service. They refused to supply us with interconnections. We were in the process of major legal battles for approximately 5 years. That was the major operation of our business, with A.T. & T. attempting to stop us in anything we did. With A.T. & T., we have been in the court of appeals in the second circuit, the third circuit, the District of Columbia Court of Appeals five times, the fourth circuit, the seventh circuit, and the ninth circuit.

Senator SPECTER. Over a 5-year period?

Mr. MCGOWAN. Over this 5-year period.

Senator SPECTER. When did that start?

Mr. MCGOWAN. It started in 1973. In 1978, we finally——

Senator SPECTER. How expensive was that battle for you?

Mr. MCGOWAN. It cost us obviously millions and millions of dollars.

Senator SPECTER. How many?

Mr. MCGOWAN. I never added up the total. I think I probably would be afraid to. The real thing it cost us and cost the consumers of the United States was a delay in building and operating our system. Obviously, A.T. & T. hoped we would go out of business, which we nearly did. However, we were fortunate in having the support of a lot of users. Finally the courts just refused to go along with what Bell did.

Mr. Chairman, there are really three industries in telecommunications. I think it is very helpful to understand that they are three distinct industries. One is local exchange service. The second is long distance. A third, which Mr. O'Kelley referred to, is equipment. These three industries collectively provide telephone service.

Bell uses its monopoly power that it has in all three industries to thwart competition in any one. In our case, in the classical terminology of antitrust law, A.T. & T. controls the essential facility, or the bottleneck, if you will, which is the local exchange service to which we must interconnect in order to provide long-distance telephone service to our customers.

We are like an airline. We go between the cities, but we need a central local facility to get to the airport where we provide our service.

Senator SPECTER. How about the local facilities themselves? Do you need Bell to tie in there?

Mr. MCGOWAN. Absolutely.

Senator SPECTER. Do you have any problem with getting the local facilities?

Mr. MCGOWAN. That has been the one problem in this industry. Bell uses their monopoly power. They have a granted monopoly for local telephone service in these communities. They use their control over those Bell operating companies with monopoly power to refuse us our interconnection, or either overcharge us for that service, or else give us poor quality. They do all three.

Senator SPECTER. You have described the litigation that was undertaken on the long distance line. Did you have similar litigation problems on the local service to interconnect?

Mr. MCGOWAN. The major problem was on local because we build and operate microwave systems to connect these cities together. We would be able to provide the service over our microwave without any problem, but we could not provide the service because Bell would not give us the interconnection in the city.

We have to go from our terminal, our airports—we call them terminals or toll offices in our industry—to where the customer is, to his home or business. Bell controls that. They have a granted monopoly for 80 percent of the telephones in the United States. Certainly all of the major cities are dominated by the Bell System, such as Washington.

Senator BAUCUS. Excuse me. May I ask a question at this point?

Senator SPECTER. Certainly.

Senator BAUCUS. If I have a telephone in my home and I want to connect up with your long distance system, do I have a separate phone?

Mr. MCGOWAN. No. The way it works, Senator, is you would pick up the telephone. You would dial a local number, which would be our number that we would give you. Our computer would answer. Then you would go on our system to the other city. We would complete the call through the telephone company that is in the other city.

If you were a businessman, like the telephone facility that is in this building, you would be permanently connected. We would lease circuits from C. & P. from this building to our closest terminal. Therefore, you would dial an extension because you have sufficient traffic to justify permanent connections to our system. It depends on whether you are a large or small user how you access our system.

Senator BAUCUS. In some cases, Bell just refused access?

Mr. McGOWAN. Absolutely. They would refuse those, and they would also try to charge us excess monies for that service so that we would be penalized economically. S. 898 allows them to continue to do that.

Senator BAUCUS. Thank you.

Senator SPECTER. Mr. McGowan, how do you make a determination that there are excess charges?

Mr. McGOWAN. For example, we take a look at what Bell has filed in the case of rate increases or rate changes in which they make sworn statements as to what it costs them to provide a service. We have found that where they provide exactly the same service for themselves, it would be like one-tenth of what they want to charge us and one-fifth of what we are paying today. Yet at the same time, this bill, the way it is written, will allow Bell to charge us 10 times over what it costs them to provide the service.

To give you an idea, in Washington, D.C., the connections we get from C. & P. are plain, ordinary telephone numbers. We order 50 at a time or 100 at a time, but they are exactly the same as you get at your home or that are in this building.

Instead of paying what Bell in the C. & P. area says cost them approximately $25 a month to provide that service, we are paying $130 for just plain telephone service. As a matter of fact, for half of our connections, we do not even make any calls. The customer calls us. We are not even making any calls. We are just receiving calls and we are paying over $130 a month for a phone number. They want to double that and S. 898 does nothing to stop that.

As a matter of fact, the mechanical part of that is set up to give them the freedom to do that. I think the access arrangement for the long distance competitive market—it is getting more and more competitive—is the most critical part of the failure of S. 898 to provide for any competition.

There is the beginning of competition. It is not big yet, but it is growing. There are more and more people coming in. MCI is not the only provider of long distance service. There are other people.

Senator SPECTER. Would it be a significant improvement on S. 898 to require that Bell offer service to you at the same cost as to others?

Mr. McGOWAN. It should certainly require that. It should certainly require that the FCC determine in an evidentiary hearing—so that Bell does not end up filling the room with paper, which they do typically at these rate proceedings and you can never figure it out because they are not going to give it to you—but in an evidentiary hearing for the FCC to find out what is the actual cost of providing these connections. What is the actual cost of C. & P. to connect to Long Lines? What is the actual cost for them to connect to us?

Based on an evidentiary hearing with that, then through the mechanism of a joint board, both Federal and State, they will have the evidence of what the charges should be.

Senator SPECTER. You are talking about unfairness in that MCI is charged more than any other customers?

Mr. McGOWAN. That is right. I think the bill should specify that we should only pay for what it costs. I think there should be a mechanism set out so that you can determine that and not believe Bell because they lie.

Senator SPECTER. The actual costs would be different than what Bell is charging another customer?

Mr. McGOWAN. It could be different, yes, sir.

Senator SPECTER. Are you suggesting that Bell ought to sell to you at actual cost or simply at what they are charging another customer?

Mr. McGOWAN. I think it should be sold to us at cost. In our industry, by the way, the word cost of course includes a profit, a fair rate of return. They should be allowed and be instructed to charge us what it costs, including a fair rate of return, for the service they provide us.

Senator SPECTER. When they charge another customer, is that a different figure, actual cost plus the fair rate of return?

Mr. McGOWAN. No. They would also not be allowed to discriminate between MCI versus somebody else who was getting similar service.

Senator SPECTER. My question is when Bell makes its charge to a regular customer other than MCI, does it charge at something other than cost plus a fair rate of return?

Mr. McGOWAN. They claim that in the case of residential customers they charge them less than what they would normally charge them if you calculated cost plus fair rate of return. When it comes to business customers, which is the analogy I used because I think we use a local phone much more closely to the way a local businessman uses the local phone, then they claim that that is a fair rate of return, that that is the cost and a fair rate of return.

Senator SPECTER. You think MCI should pay the same as any other business customer and you would like to see the legislation changed at least in that respect?

Mr. McGOWAN. Absolutely. We seek different types of interconnection, and we are not getting treated the same as Long Lines. For example, they refuse to pass on to us rotary dial, and if you happen to have a rotary phone, which over 60 percent of the people in the United States have today, you cannot use MCI because they do not pass those signals on to us where they do pass them on to Long Lines. They refuse to pass them on to MCI and the other specialized carriers.

We are seeking other types of connections. In so doing, if we cause expense to be incurred, I think we should be charged for that. If we do not cause expense to be incurred, then we should not. Bell has claimed that it would be extremely difficult to do that.

We announced 3 weeks ago an agreement we made with Northwest Iowa Telephone Co., a small telephone company in northwest Iowa. They were willing to provide us with all the connections, all the quality, all the types that we had been asking from Bell

System. They could do it within a week. It is simple for the industry. The industry knows it is simple. Bell knows it is simple. Yet they go through with this charade that it would cost billions to allow people to reach us the way they reach Long Lines.

For example, at Northwest Telephone Co., which is independent and is not controlled by Bell, when you want to use Bell long distance, you dial one and then the area code and number. If you want to reach MCI, you dial six and the area code and number. The customers have a choice as to who to use.

They do not need to put in that code that I described before. When you dial into us, you put in your authorization code which requires people to dial 22 digits and they must have a touchtone phone. In Northwest Iowa Telephone Co., they can dial, from a rotary phone, the same number of digits used to access the Bell network.

At the end of the month, Northwest Iowa Telephone Co. tells us—they keep track with automatic number identification—and we process the billing. We send them a tape and they incorporate it into their billing. The Northwest Iowa customers will get a bill and it will show their long-distance calls on Bell and how much to pay and their long-distance calls on MCI.

With MCI, you save about 25 to 50 percent below what Bell charges. We believe we can prove that we can construct and operate a long-distance communications system in this country far less expensively than A.T. & T.

Senator SPECTER. How are you able to do that?

Mr. MCGOWAN. For one, we are not a rate-based company. We are not bloated as they are with people and overhead.

As an example, I will give you one figure. I think an excellent way to measure efficiency of companies is to measure what their revenues are relating to their plant investment and what their revenues are relating to their people.

If you take a look at A.T. & T., they claim the most efficient part of that business is the Long Lines department because they are not a local phone company. That is the most efficient. A.T. & T.'s revenues in their Long Lines department per year is $87,000 per employee.

MCI last year was over $130,000. Right now, we are running $150,000 in revenue per employee, nearly double. I am comparing it at our rates versus theirs. If I was charging their rates, we would be earning $170,000 per employee, which we really should because as a capital intensive business, you certainly should not be people intensive.

Senator BAUCUS. Does that include local exchange employees?

Mr. MCGOWAN. No, only Long Lines. Local exchange is $47,000. All of the Bell put together, excluding Western Electric, is $47,000 revenue. However, I am counting only Long Lines because I think that is a fair comparison because they only operate a long distance network.

By the way, Long Lines does not have a lot of people we are required to have. For example, we are a public corporation. We have 35,000 stockholders. We have to deal with them. We have to go out and raise money. Long Lines does not do that. Corporate headquarters does that. We have to invoice our customers. Long

Lines has very few accounts. The local phone company invoices for them. Therefore, there is even greater discrepancy.

Bell is trying to hide the efficiency we have by their control of that local phone company. That local phone industry is an essential facility.

We finished a trial on the 13th of June, 1980, an antitrust trial. A jury found Bell guilty of violating the antitrust laws. They found them guilty of three counts of denying us interconnection.

Senator **Specter**. Where was the case docket?

Mr. **McGowan**. In Chicago. They found them guilty of tying in local service to A.T. & T. Long Lines service. In other words, you have to buy all or you get none, a classical tie-in case.

They found them guilty of interfering with our customers by disconnecting them.

Senator **Specter**. This is MCI versus Bell?

Mr. **McGowan**. A.T. & T., yes, sir.

They found them guilty of providing inappropriate or inefficient equipment or procedures for interconnection. They found them guilty of predatory pricing against us. They found them guilty of preannouncement of new service in an antitrust sense.

Senator **Specter**. Were there special interrogatories to the jury? How did they make all those specific determinations? Was it a jury trial?

Mr. **McGowan**. It was a jury trial. All of these were given with instructions. I have included as an appendix pages which will show the instructions given to the jury for them to determine that.

Senator **Specter**. What damages were awarded?

Mr. **McGowan**. The damages awarded were $600 million.

Senator **Specter**. That may account for their higher cost per employee.

Mr. **McGowan**. When they pay it, I presume that number would go up, yes. So far, we have not seen those funds.

Senator **Specter**. They may have accrued it.

Mr. **McGowan**. That award was prior to trebling.

They found them guilty of negotiating in bad faith for those interconnections.

Senator **Specter**. Does a verdict of a billion, $800 million, when trebled, have any real impact on A.T. & T. in your judgment?

Mr. **McGowan**. The jury decision certainly has not had any impact on their conduct. The fact that they were found guilty does not seem to have influenced their attempt to try and put us out of business. When they write the check and give us the money, it probably is not going to have that much impact on them then because there is a company that is doing well in excess of $1 billion a week in revenue. They are running at an after-tax profit rate which I think is $6.5 billion.

Senator **Specter**. Have there been any settlement discussions in that case?

Mr. **McGowan**. No, there have not been.

Senator **Baucus**. Mr. Chairman, I wonder if I might ask a question? After this vote, I will be unable to return.

Senator **Specter**. Sure, go ahead.

Senator **Baucus**. I wonder if you could give to me the best argument that the Bell System makes for its practice and why it is necessary, and then next, your best argument in refutation of theirs. What is the best argument that Bell can make on its behalf?

Mr. McGowan. They make a lot of arguments on different subjects.

Senator Baucus. In your judgment, what is the best argument they have? Their best argument is what?

Mr. McGowan. About their company?

Senator Baucus. About why they have to be able to decide who they can provide long distance service to and why they have to charge more to, say, MCI than they do to other customers? What is their best argument?

Mr. McGowan. One of the most frequent arguments I hear is they say that the reason we should pay much more than anybody else for getting the same service is that they, in their long distance bill, overcharge the customer because they use some of that money to subsidize local telephone service.

In other words, they claim that there is a shift of money in this industry. They say they overcharge the businessman to pay residential. Then they say they overcharge urban to pay rural and overcharge long distance to pay local. They say that since they do it, we should be forced to do it.

We say that when Bell does it, they take it from one pocket and put it in the other. The telephone industry does not subsidize anybody. I mean obviously it is not them. It is somebody else subsidizing him.

We say that if there is that subsidy, you should charge fair prices. I mean if there is any need for any section or some people in the country where they would pay an extremely high price because of some unique nature—let us say rural—then they could have a mechanism to be able to allow them less expensive access into the network.

However, for Bell to say that they want to continue to subsidize a business customer or a business phone, which is what they claim they are doing, I think is crazy.

Senator Baucus. Do they overcharge REA's?

Mr. McGowan. You have to understand that Bell is usually not typically where the REA's are. Most of them are covered through the independent telephone industry. Bell has less coverage of the United States than the independents do, although they have 80 percent of the phones. Most of that REA is done through cooperatives, small telephone companies that are owned by some of the independents or one just owned by itself.

Senator Baucus. Does Bell tend to overcharge or discourage access to Bell to those independents compared to MCI?

Mr. McGowan. Bell interconnects with the independents. The independents just have local telephone service. Rarely do they have any long distance. They are just local telephone service. Bell interconnects their own companies as well as the independents.

Senator Baucus. Thank you.

Senator Specter. The buzzers mean that we are running close on a vote. We will have to adjourn at this time. We will be back within the course of 10 minutes to resume.

[Recess taken.]

Senator SPECTER. Mr. McGowan, we will resume with your testimony.

Mr. McGOWAN. A key provision of S. 898 removes the most important element of FCC control over the establishment of fees for access by interstate carriers such as MCI to local exchange facilities. The allocation of the local exchange plant cost to intercity carriers interconnecting with local systems is, under 898, done by a joint board which has FCC members but whose majority is to be nominated by a professional association representing State utility commissioners.

What will be the motivation of this joint board? I believe, as they have demonstrated in the past, it will be to load costs on that part of the telephone operations for which the FCC is responsible, in other words, on intercity carriers and their customers.

The reason they are going to do this is because A.T. & T. has given them every incentive to do so. Bell is now seeking what I consider outrageous local rate increases from State commissions nationwide.

In 1980, Bell suddenly more than quadrupled the rate increases demanded in local areas. Between 1975 and 1979, Bell sought between $500 million and $1 billion each year from State commissions. In 1980, A.T. & T. went in for $4,500 million.

Senator SPECTER. Do you think their requests are too high?

Mr. McGOWAN. Yes.

Senator SPECTER. Do you ever participate in opposition to their requests?

Mr. McGOWAN. Yes, we have. We are active participants, for example, in the State of Texas where we provide intrastate service. We participate in those proceedings, in which case we have been told at least by certain members of the staff that they welcome it because most State commissions do not have the resources to actively get involved in understanding what the phone company has filed. Therefore, they are kind of helpless to do much about it.

Senator SPECTER. How much competition do you give them in Texas intrastate?

Mr. McGOWAN. In Texas, we connect in about 35 cities. We supply, I would hazard a guess, maybe 80 to 90 percent of where the telephones are in Texas. That would probably be more substantial in Texas than in most areas.

Senator SPECTER. Eighty to ninety percent of the areas where telephones are in Texas?

Mr. McGOWAN. Yes.

Senator SPECTER. What percentage of Texas telephone service would MCI give that?

Mr. McGOWAN. We would still be very small because the long-distance telephone service is a high growth business. It is probably going to double between 1980 and 1985 or 1986. It has been compounding itself.

Senator SPECTER. You provide only long-distance service in Texas and no local service in Texas?

Mr. McGOWAN. That is right. We are not a franchised local telephone company. We only provide long-distance between the cities.

Senator SPECTER. That is everywhere as well as Texas?

Mr. McGowan. Yes; we go from east coast to west coast. The two areas where we are not fully covered yet are the Southeast, where we are now just starting to provide service, and the Northwest, where we are planning on starting to provide service this fall. We will have the geographical areas all covered, but we still will not have all the cities. We will then start branching out and extending out to pick up all the rest of the cities.

The point I was making before was this past year A.T. & T. growth in long-distance was a little in excess of $3 billion.

Senator Specter. $3 billion in growth?

Mr. McGowan. Yes.

Senator Specter. That is total revenues?

Mr. McGowan. That would take them to approximately $30 billion.

Competitors this past year had a total volume of about $400 million. Therefore, you are talking about a total competitive volume of a little over 1 percent of their growth.

Senator Specter. Do you provide long-distance service out of the Washington area?

Mr. McGowan. Yes, we do. We provide long-distance service from Washington to any of the systems on our circuit.

Senator Specter. What number do you punch?

Mr. McGowan. You would receive a telephone number. We have 9,000 customers in Washington.

Senator Specter. Is the U.S. Government one of your customers?

Mr. McGowan. Yes, they are. We supply service for DOD.

Senator Specter. The U.S. Senate?

Mr. McGowan. We are in the process now. The Senate and House may both use our service. In addition, there will be given to us this week a substantial number of circuits from GSA which would then provide service for the rest of the Government. I would hope within a matter of several weeks a substantial part of your long-distance telephone calls are going to be on our system.

Senator Specter. Will that be significantly cheaper than the current costing?

Mr. McGowan. Oh, yes. That is the reason they have come to us. They have found that with Bell, Bell's rate increases seem to be going up and the competitors offer a substantial savings. They had been reluctant in the past to do so because Bell had a service offering called Telpac, which was volume discounts for individual circuits. The circuits were the same, but if you bought a certain number, there were volume discounts.

Bell withdrew from that offering because the Commission ordered them to allow reselling of it. Therefore, people could buy it and resell it. They realized that that blew their cover and therefore they had to price it at what they should charge for it. The Government bill went up and they have now come to competitors.

Senator Specter. You were starting to comment about an individual's tie-in to your system. You say they get a separate number?

Mr. McGowan. We give a phone number and we give a personal identification number which identifies you to the computer so that the computer checks and sees that you are authorized. It is a little bit like a credit card number. When you call into our computer, you then put in on your touchtone pad your personal identification number. Then you put the area code and phone number you want to call.

The computer checks that in its memory to make sure you are authorized. If you are not authorized, it would reject you. If you are authorized, it takes the circuit to that city and dials the local phone number that you have put into the computer. It takes about a half a second for that process. You are now on one of our circuits. The computer then keeps track of your call.

At the end of the month, you get a bill which outlines each call you made and the price for it. We have different prices for different times of day and differenct distances. We price it that way.

Regarding the establishment of rates, I think Bell is provoking the sort of reaction by State commissions which will be most detrimental to its long-distance competitors: a joint board overallocation of costs to interexchange services resulting in excessive charges to us for local exchange.

Moreover, S. 898 requires surcharges on top of the access fees to subsidize something called basic telephone service. When you look at the definition, you find that that is defined as local and long-distance service. In effect, you set up the horrible and ridiculous anomaly of the possibility that they are saying to this board that the board is allowed to force MCI to pay more to subsidize Bell's long-distance telephone service in the way it reads. Obviously, only A.T. & T. can stand such distorted access.

Senator SPECTER. Would you repeat that one?

Mr. MCGOWAN. In S. 898, they say that on top of the access fees, they are allowed to subsidize something called basic telephone service. They define basic telephone service as local service and A.T. & T. long distance service. That is what we compete with. It says that they can put in the access fee charge literally an extra charge to us in case they find it necessary to subsidize basic service.

Senator SPECTER. How would you recommend an amendment to that provision?

Mr. MCGOWAN. I would eliminate it. I would think that on its face it is part of the confusing language that is in S. 898 in trying to determine what it all means. I believe they should have in there a statement that we should not be charged for more than the actual cost of providing that service for us.

I do not believe it is in favor of competition. I think it is against competitors to allow the possibility of them being overcharged for it. This bill is supposedly designed to help competition. It certainly does not do that in our industry. It goes against the competitive standing of our industry.

Senator SPECTER. You think there is no merit at all to anything that A.T. & T. has contended, that they have to make some overcharges on some aspects in order to make up for losses on other aspects?

Mr. MCGOWAN. I think that there could be some, but this industry, the way they handle the money among each other, is thoroughly wormy and encourages, I think, extremely inefficient operation because nobody knows actually what things cost. In effect, the industry decides itself how this money should be spread around.

They would state to you, if they would ever show up, that they have to do something under separations and settlements which is prescribed by the FCC and therefore they have no choice as to how this money is turned around from person to person.

However, the FCC just completed a study last year of that separation process. The people who did the study found that the FCC did not have anything to do with it. It was Bell that dominated the separation and settlements. It was Bell that determined who got what money, when, where, and how.

You are talking about an amount of money which may very well be in the $6 billion range. This industry itself decides that they are going to have the moneys transferred. Bell splits it up among itself in something called division of revenue. They split it with the independents in something called separations and settlements.

If you talk to the people in the independent telephone industry, most of them do not even know how it is done. It is a Bell dominated process. They have obviously done it for their own competitive purposes. This bill allows that process to continue.

I think the bill should specify that the FCC is required to have an evidentiary hearing to determine the costs. I mean evidentiary so that the parties who are involved, like us, can force answers and can get witnesses and force Bell to give the true facts. Then you could have a joint board to determine it based on that evidentiary hearing.

The FCC is the best one qualified of anybody in the regulatory involvement. Sure, they do not have all that much in the way of staff. Sure, they have all the problems of any other Government agency trying to get on top of an industry like this. However, of anybody involved, they are certainly the best ones.

S. 898, for example, never asked anybody to present evidence on costs. They never said we want to know what things cost so we can write a bill to be able to have competition which relates to projection of true costs more prevalent in these industries.

Senator SPECTER. Are there similar provisions in other parts of the law which set a precedent for this kind of a cost determination with an evidentiary hearing with someone like yourself coming in to offer evidence?

Mr. McGOWAN. Yes. There are proceedings at the FCC quite frequently where interested parties can participate in that process, can put on witnesses, can send interrogatories to Bell to demand answers, can get Bell witnesses, can get Bell numbers, can do their own studies, and put on their own witnesses.

Senator SPECTER. How does that kind of a discovery process work? Does Bell respond? Do you have to get Commission orders?

Mr. McGOWAN. Yes. You would have to have the Commission order them because when you try to do it other than that, Bell will just not give you the information, or they give you information which is pretense information. It is just tons and tons of paper. When you go to examine a study, you find that everything is based on some study which is based on another study which is based on another study.

We tried to track them through one time. We found that a lot of it was based on things done 30 and 40 years ago. They allocate costs in an unbelievable fashion that, to me, had not been in the regulated utility involved. To see the way they allocate costs in this industry would horrify any businessman.

For Congress to say we can take this industry and make it competitive without having the information of the proper cost involved and the various aspects of it, you have an anomaly here which has never to my knowledge ever happened before. You have an anomaly here where you have equipment which is getting quite competitive, and you have long distance which is starting to be competitive, but they both connect to this local franchise monopoly. Bell has the control over that. Bell is the one that controls that.

When Mr. O'Kelley made the comment before about the fully separated subsidiary, I agree with his point. I have subsidiaries. If an employee of one of my subsidiaries does not do what he knows I want him to do, he becomes a fully separated employee the next day.

Senator SPECTER. Do you think Mr. O'Kelley is correct about a fully separated publicly held company as adequate to guarantee competition?

Mr. McGOWAN. If it was a separated company with separate stockholders.

Senator SPECTER. You think that would be sufficient.

Mr. McGOWAN. That would be sufficient.

Senator SPECTER. I am sorry to interrupt you again, but I must. At this moment, there is a markup for the Appropriations Committee which I must attend. Senator Grassley is due to arrive here to carry on these hearings until I finish that responsibility.

I want to explain to you that while this hearing was set long before Appropriations set its hearing, Appropriations must set its hearing immediately after the House acts and there is a very urgent timetable there which requires the double scheduling. I have to go there to make up a quorum and also to participate in certain of the issues. I will be back as soon as I can, but in any event Senator Grassley is scheduled to be here to continue with the hearing.

Mr. McGOWAN. Thank you very much, Mr. Chairman. I appreciate your time.

[Recess taken.]

Senator GRASSLEY [acting chairman]. At the time of the adjournment of the committee for purposes of going to the floor to vote and because Senator Specter had to leave, we were going to give Mr. McGowan and Mr. O'Kelley an opportunity to summarize, which we would like to do at this point.

Also, I would like to suggest that there will be questions submitted to the panel in writing. We would appreciate your responding to them. I presume that would probably be applicable to some of the other witnesses as well.

Mr. McGowan and Mr. O'Kelley, would you like to proceed now?

CROSS SUBSIDY SHOULD BE AN UNFAIR TRADE PRACTICE UNDER THE ANTITRUST LAWS

Mr. O'KELLEY. Yes, sir. I am Mr. O'Kelley, Mr. Chairman.

I have two comments that I have not previously made that I would like to get into the record relative to S. 898. I would suggest to you, sir, that it be considered that if in fact under S. 898 the A.T. & T. organization is found guilty of cross subsidy, this should be made an unfair trade practice subject to the antitrust laws. Also, a provision should be made in the legislation that would permit a private cause of action in the event that cross subsidy is proved.

S. 898 WOULD GIVE A.T. & T. A TELECOMMUNICATIONS PATENTS MONOPOLY AGAIN

Second—and in order to explain this I need to go back slightly in history—one of the requirements of the 1956 consent decree was that A.T. & T. and its subsidiaries were required to license the patents that they held to other companies. This is a very important requirement that was reached in that consent decree which was a consent decree resulting from an antitrust suit, *Justice* v. *A.T. & T.*

A.T. & T. has something in the area of 12,000 patents. The current legislation, S. 898, eliminates the requirement that A.T. & T. license those patents to the rest of the industry. Therefore, by refusing to permit license of those patents, A.T. & T. would be able to drive competition out of the business.

The provision of the consent decree of 1956 relative to patents, in my judgment, should be kept in the full force of law. I suggest that S. 898 needs to make provision for this.

Thank you, Mr. Chairman.

Senator **Grassley**. Mr. McGowan?

Mr. **McGowan**. Mr. Grassley, two very brief comments: I think if there is any restructuring to be done, and lord knows this industry certainly needs it, I think it is ideally done along the natural divisions in this industry rather than the artificial distinctions which S. 898 presently proposes.

Telephone service is provided by three industries: equipment, local telephone service, and long distance. Any structure should recognize the natural divisions. They differ from each other in technologies. They differ from each other in methods of providing the service. They differ from each other in degrees of capital intensity versus people intensity. They differ from each other sufficiently so that any structure would be able to be along those natural dividing lines.

MCI is a long-distance telephone provider. It has been consistently frustrated. Our direct competitor, A.T. & T., also controls through the Bell operating companies the local telephone service.

I had mentioned earlier where we had found an independent who did not provide long distance telephone service, where they say they do not have a vested interest in long distance, they have been willing to treat us as equal to Bell.

I will read one paragraph from Telephony magazine of July 13, 1981, where it talks about one of the independent telephone companies who is willing to treat MCI as an equal with Bell.

> Northwest Iowa Telephone Company, Sloane, has reached an access agreement with MCI, Washington, D.C. MCI long has been depicted by telco leaders as the archetype of the "cream-skimmers," a polite epithet used when "parasite" would not do. They said competition was a fact of life. Lip service was paid to not trying to turn back the clock. But their economic world was still defined as "them" versus "us."

Customers will use MCI service, according to Charles A. Long, vice president of Northwest Iowa Telephone Company. He expects people to chose MCI because MCI's rates are 20 to 60 percent less than the comparable Bell system rates. These are savings no one can ignore.

The deal punctuated the tired myths that MCI could not be accessed by dialing a single digit and using a rotary dial telephone. MCI indicated that the Iowa Telephone customers will be able to do both. This gives lie to the old industry assertions that MCI lived under a severe technological handicap which constrained its service and its market.

What about the poor service telco leaders have repeatedly said their competitors offer? "We believe the time has come for our customers to be able to benefit from MCI quality of service and low rates," said Mr. Long, casually kicking the quality of service myth out of the way.

Low rates, good service, customer choice.

Sounds like higher calling volumes and increased revenues. Sounds like a small telco unwilling to divide its economic world into "friends" and "enemies" and deal only with "friends" regardless of the economics involved.

Sounds like a competitive company.

Sounds like a competitive market.

Sounds like independence.

Thank you, Mr. Chairman.

Senator **Grassley**. As I suggested, we will submit questions to you in writing.

I want to apologize for being a half hour late. I thought the panel would be continuing. I took an opportunity to make some calls back to my State to handle some constituent business. Otherwise, I could have been here at 2 o'clock. I want to apologize and not give you an excuse why I was not here, except to say that if I had known that the meeting was not proceeding due to my absence I would have been present.

Mr. **McGowan**. Mr. Chairman, whenever anybody is using the telephone, it is certainly a good excuse. We like to encourage that, especially long distance.

Senator **Grassley**. Thank you very much.

[Material follows:]

STATEMENT OF

HAROLD E. O'KELLEY

President, Chief Executive Officer
and Chairman of the Board
Datapoint Corporation

RE: The Effects on National Security and Emergency Preparedness of Competition and Deregulation in the Telecommunications Industry

Thank you for the opportunity to express Datapoint Corporation's views to the Defense Communications Agency concerning the effects of competition and deregulation on national security and emergency preparedness.

I have taken the liberty of attaching a copy of the statement I recently delivered to the Subcommittee on Telecommunications, Consumer Protection, and Finance of the Committee on Energy and Commerce of the U.S. House of Representatives.

We have studied the document titled "A Review of National Security - Emergency Preparedness Telecommunications Policy" dated February 1981 (the "Document"). While we understand that the Document does not represent the views of the Department of Defense nor of the Defense Communications Agency, we believe many of the concerns of DOD and DCA are expressed therein.

We believe a fundamental flaw exists in the Document in that it fails to acknowledge that AT&T is a publicly owned corporation whose sole objective is profitability. Its goals and those of Datapoint and any other public corporation are in the broadest sense, identical. We believe that profits are a proper goal for public corporations.

We agree with the Document that a survivable national telecommunications system buttresses the deterrence to nuclear war and that Telecommunications capabilities are critically important in the pursuit of peace through strength.

The Document describes the technical attributes of a system that would satisfy NS/EP requirements to be:

Available in time of need on a priority basis;

Readily accessible at many points;

Responsive to distributed control;

Extensively interconnectible and manipulable to provide many alternative routes;

Flexible in terms of sharing and preemption; and

Capable of handling a variety of communications.

Technically, a national survivable telecommunications system would consist of a nationwide backbone network with multiple linkages among government, carrier and private networks that would be used to reconfigure communications routes. The network should be so highly interconnected that the costs to an enemy to destroy all possible communications paths would be prohibitively high. We believe the Document fails to identify the importance of introducing technological improvements into the network.

The Document describes the nontechnical attributes of the system to be:

> A sound legislative basis that unequivocally recognizes the primary importance of a survivable national telecommunications system, other considerations notwithstanding, and provides for corresponding effective decision and rule making authority;
>
> A single, consistent, centralized source of policy and guidance;
>
> Authoritative executive direction backed by budgetary power;
>
> A supportive regulatory environment;
>
> A reasonable cost structure; and
>
> A realistic and appropriate financing arrangements.

We agree with this description.

The Document describes the major issues as resulting from a tension caused by conflicts of policy. It claims, "There is, on the one hand, a series of policies that is establishing competition and deregulation in the telecommunications industry; on the other, there are national security policies that require the telecommunications industry to support vital NS/EP objectives." We believe that no such conflict exists and that competition and NS/EP goals are synergistic. Continued regulation to establish and unify NS/EP goals is necessary and proper and is not inconsistent with deregulation from the point of view of establishing competition and eliminating monopolies. The threat is to AT&T's monopoly power and profits, not to national security and emergency preparedness.

The divestiture of Western Electric from AT&T means only that the operating companies and Long Lines would be free from having to consider the interests of the owners of Western Electric in selecting equipment to pursue its goals. Consider the position of a Long Lines network manager who decides to introduce priority access and alternate routing equipment into a portion of the network for which he has responsibility pursuant to objectives established by DOD or DCA. He or his superior is constrained to consider the availability of product to accomplish the task at Western Electric. If Western Electric does not have the equipment, it must determine whether to design and manufacture the equipment. Its decisions will be based on the profit impact to AT&T as a whole. If Western Electric were divested from AT&T, the decision making process would be otherwise. If suitable equipment were available from Western Electric and not from others, it could purchase the equipment from Western Electric. If available from multiple sources, the better or cheaper equipment could be purchased. If not available, it could be designed and manufactured by the supplier who could do the task best, or fastest, or cheapest. It is the goal of doing what is best for AT&T as a whole that prevents each subsidiary of AT&T from making proper decisions aligned with the interests of its customers whether they be commercial customers or government customers.

The Document argues that a monopoly structure framework would establish a single integrated system. This argument is hogwash. Certainly it would establish a system owned by AT&T in major part and by 1600 or so independent telephone companies, but it would also assure that other countries telephone networks purchased from commercially available sources such as Japanese manufacturers would be technically superior and have capabilities not available in the United States to the comercial marketplace or to the military. In fact, many military and other key government installations are located in areas serviced by independent telephone companies such as GTE. All U.S. military and government installations located in foreign countries are beyond AT&T's network. The concept of a single integrated system is a myth.

More importantly, even with respect to a technically inferior network, the monopoly structure argument fails to acknowledge the strategic importance of multiple long distance networks interconnected at as many points as possible. The introduction of competition has led to the creation of more possible paths in the event of national stress to the telecommunications network. This redundancy is the child of competition. The more networks, the more interconnections, the more redundancy, the more competitive the telecommunications marketplace, the more difficult it will be to destroy or incapacitate telecommunications. Monopoly structure rewards few paths, competition encourages additional pathways, nodes and interconnections. Alternatively stated, Monopoly structure encourages AT&T to charge more for less to meet its profit goals. An open marketplace encourages additional facilities to be brought into existence to earn profits. The incentive for all potential market entrants is that AT&T has done a poor job. If AT&T had served the needs of industry and government well at reasonable prices, potential market entrants would be few and limited to narrow market segments.

NS/EP standards should be legislatively mandated or established by the Administration, they should not be left to the hope that AT&T will subordinate its profit goal to the interests of the public.

The Document acknowledges that "it may be necessary to require the public (either as ratepayers, taxpayers, or both) to pay for ... improvements if they share in the benefits." Clearly the public will pay. There is no one else. The proper inquiry is how to pay for improvements and to assure that our money is spent wisely. Burying the cost in the ratebase and assuring a continued monopoly only assures profits to AT&T; it does not assure a telecommunications network satisfactory in NS/EP terms.

Datapoint manufactures several telecommunications products which have features not available from AT&T which have dramatic application to several of the goals described in the Document. Products developed in the commercial marketplace to fill commercial needs often find military application. The synergism is clear. The military can reap the benefit of development costs born by the commercial marketplace.

Datapoint's LDCS is a commercial product which is a long distance control system. It is a computer controlled least cost routing device. It also restricts access to the system using caller identification codes, records all calls by area code and number, records time of day, duration of call, etc. It selects the least cost route for the call, ques calls, speed dials and provides detailed management reports. It saves money. The similarity of the application for military purposes is clear. Priority access for the military could be implemented as well as levels of access priority for higher functions. The similarity of management reports to security reports is clear. The application of routing tables based on availability rather than cost could also be implemented. Western Electric does not manufacture such a product because it functions to reduce profits earned in other AT&T subsidiaries. Again the basic flaw is the structure of AT&T. If Western Electric stock were distributed to the current shareholders of AT&T, Western Electric would be free to reexamine its goals independent of those of AT&T. If it identified a military market for such equipment which in peacetime would have the advantage of reducing the cost of telecommunications service and in time of stress would provide priority access and alternate routing of calls, Western Electric would be free to design and manufacture the product without subordinating its goals to the loftier goals of the parent - owner, AT&T. Of course, money saved by DOD use of Datapoint's LDCS equipment on telecommunications could be applied to the purchase of weapons.

Datapoint recently announced a digital switching communications system for voice and data called the ISX, Information Switching Exchange. The ISX has the capacity to process thousands of voice and data connections simultaneously. With it, Datapoint computers can be attached directly to telephone wire. The ISX can provide modular, incremental growth to handle from 100 to over 20,000 voice and data ports. Datapoint's ISX has component redundancy, automatic component substitution in the event of a failure, self diagnostics and automatic failure reporting. Other features such as a 24-character alphanumeric display on the Datapoint INFOSET II telephone facilitate the display of information such as the identity of the calling party, call back messages and called number verification, are described in the attached product brochures. Reliability standards are being set in the competitive marketplace by manufacturers such as Datapoint, not by Western Electric which is without incentive to innovate. Redundant circuits and automatic substitution of components are featured in

Datapoint's ISX not to meet NS/EP standards but because the commercial marketplace demands a level of reliability superior to that routinely provided by AT&T. DOD and DCA are entitled to no less a standard. Continuing or expanding AT&T's monopoly will prevent new standards of reliability from being introduced into the telecommunications marketplace and if AT&T is permitted to subsidize its activities in the computer marketplace, will stifle innovation and technology in that marketplace as well.

DOD presently limits the export of certain computer technology to unfriendly nations. The U.S. has developed the superior computer technology in the commercial and competitive marketplace. It would be a sorry state of affairs to disrupt so innovative an industry by permitting AT&T to cross-subsidize its activities in the computer industry from excess profits reaped as a result of its telecommunications monopoly. Predictably, the U.S. would no longer have to worry about restraining exports of such products because we likely would not have them to worry about. The adverse impact of extending AT&T's monopoly extends to the computer component manufacturers as well. Companies such as Intel, Mostek and TI depend upon non-vertically integrated companies like Datapoint as consumers of their high technology components such as LSI circuits, infrared communications devices, lasers, and microcomputers made from semiconductors. Profits from component sales helps support their research and development expenses. If the consumers are driven out of the market, then so will the suppliers. Vertically integrated companies like Western Electric and IBM will continue to produce and consume their own products, but the innovation of many others will be lost. Separate ownership of Western Electric and independence of profit goals from AT&T are surely the only method to unleash Western Electric's capabilities without damaging the innovative edge of the U.S. computer marketplace.

The Document noted, ". . . the organization and authority for telecommunications policymaking and development has been shifted back and forth within the Executive Branch repeatedly over the past 30 years. In large part, this is because it lacks a statutory basis. As long as it is not set by law, telecommunications policymaking and development will continue to lack a stable, long-term, institutional basis." We agree that present law doesn't provide adequate planning guidelines and leadership. There is a need for legislation which provides for planning, coordination and direction and which assures that such functions will not be captured by one competitor to exclude all others.

The Document cites Xerox's XTEN as an example of recent intercity entrants. As you know, XTEN has been terminated because it was not profitable. Xerox's $30M loss is substantial, but more relevant, is the loss to the network of multiple additional pathways which would have made the network more secure. AT&T's domination and control of the network is responsible in part for the XTEN failure. Access charges, often discussed in the Document, should not be permitted to be a rein in the hands of AT&T on competition under cover of facilitating payment for NS/EP improvements.

The Document states, "Much of the anxiety in the NS/EP community stems not only from the perceived threat of a Soviet attack, but also from potential impacts of competition and deregulation, particularly as they affect more fundamental, architectural, or system-level operation and planning of the telephone system." Legislation which provides for divestiture and regulation of the network through public planning and operation would assure not only lower priced telecommunications, enhanced services through introduction of innovative products by Western Electric and others, but could also secure NS/EP goals as well.

We urge DOD to reconsider its position. We believe that proper legislation, not Senate Bill 898, is desirable. We also believe that the goals of DOD for a secure telecommunications network is consistent with divestiture of Western Electric from AT&T. Proper legislation can be drafted and enacted in a timely manner if supported by DOD and the competitive computer and telecommunications manufacturers. DOD's support of divestiture of Western Electric could result in establishment of proper NS/EP priorities, substantial improvement in service, savings in expense, network redundancy and settlement of the U.S. v. AT&T antitrust case.

TESTIMONY OF

HAROLD E. O'KELLEY

Re: Competition and Deregulation in the
Telecommunications Industry
Senate Bill 898 --
An Extension of Monopoly Power

My name is Harold O'Kelley. I am the President, Chief Executive Officer and Chairman of the Board of Datapoint Corporation, headquartered in San Antonio, Texas. Datapoint Corporation is a public corporation founded in 1968 and has become a leading manufacturer of data processing and telecommunications equipment with revenues of approximately $400M per year and approximately 6500 employees. Datapoint exports approximately 40% of the products it manufactures. It should be noted that AT&T is one of Datapoint's largest customers for computers.

Datapoint endorses the overall objective of Senate Bill 898 to establish a national policy promoting reliance whenever possible on competition and the private sector to provide telecommunications services and products, and to reduce or eliminate unnecessary regulation of telecommunications services and products. After carefully analyzing the bill, Datapoint has concluded that its enactment would be detrimental to competition in the presently unregulated data processing and telecommunications markets.

Datapoint opposes Senate Bill 898 because it is firmly convinced that only by totally separating AT&T's competitive operations from its monopoly operations can Congress prevent AT&T and its monopoly affiliates from granting unfair assistance to a competitive affiliate. The clear effect of Senate Bill 898 would be to introduce AT&T's monopoly powers, sanctioned by Congress in the 1934 Communications Act, into presently competitive markets.

Senate Bill 898, if enacted, will assure a great period of prosperity and growth to AT&T at the expense of existing industry and the public. In my view, enactment of Senate Bill 898 will result in future congressional hearings to examine the loss of United States leadership in computer technology, the concentration of market share in the information industry, the exorbitant cost of telecommunications service and the creation of another government agency to untangle the web. Senate Bill 898 will not only fail to accomplish its stated objectives, but, in my view, it is deceitful. Your successors in office will hear AT&T officials testify that technological development in the United States has not slowed, but that other countries have caught up, that AT&T's monopolies in many industries are the result of more efficient operations due to economies of scale and not cross subsidies, that AT&T and its fully separated affiliates combined and agreed only on matters concerning the network and that such combinations and agreements were lawful pursuant to the special antitrust exemption granted by Senate Bill 898, and that the rapid rise in the cost of telecommunications services is due to inflation, rural telephones, competition, unnecessary regulation and excessive litigation.

Senate Bill 898 should be revised to provide for the division of AT&T into three publicly traded corporations.

1. "AT&T - Western Electric" should be permitted to operate in all unregulated markets.
2. "AT&T - Long Lines" should be subject to transitional FCC regulation of rates until such time as meaningful competition exists in the interstate telecommunications market or relevant portion thereof. The FCC should be granted jurisdiction over all parties connecting to the network, set standards for connection to the network and have enforcement authority for breach of its rules.
3. "AT&T - Operating Companies" should be regulated by the several states and the operations of each operating company should be limited to providing local telephone service. It should not be permitted to vertically integrate. "AT&T - Operating Companies" should own Bell Labs and all AT&T patents presently in existence. It should be obligated to license its patents on a non-discriminatory basis.

The FCC should have continuing jurisdiction over all parties connected to the network concerning such matters as standards for connection, national security and emergency preparedness as well as services for which meaningful competition does not exist.

Division of AT&T into three publicly owned corporations would assure application of the antitrust laws to each of the three AT&T companies in the same manner as they apply to others.

In my view, each of the three AT&T companies would establish different goals and objectives:

1. "AT&T - Western Electric" would seek to protect its existing market share in telecommunications as well as to penetrate markets new to it, such as the manufacture of computers and the sale of components manufactured by it. For a time, it might be able to demand higher prices for telecommunications equipment because competitors would not have sufficient manufacturing capacity. This temporary advantage would give "AT&T - Western Electric" sufficient time to develop competitively priced innovative products to replace present board room agreements which require the operating companies to purchase equipment from Western Electric. "AT&T - Western Electric's" long term survival and profitability would thus depend upon its efficiency, innovativeness, marketing skills and independent management. This is contrary to the present result of Senate Bill 898 which will leave

Western Electric with the benefit of monopoly subsidiaries and incomplete incentives to innovate.

2. "AT&T - Long Lines" would similarly have to develop new skills. Despite its entrenched position, it would be required to improve service in areas of deficiency or face new competitors in the marketplace. Its ability to compete would be enhanced because it would no longer be required to limit its purchases solely to equipment manufactured by Western Electric, and Western Electric would no longer have board room power to dictate purchase prices. Lower prices for improved service and the development of new markets would clearly become its goals.
3. "AT&T - Operating Companies" would establish improvement of local service and economy of operations as goals. Inflating the cost of equipment would no longer be a convenient method of improving AT&T's profits. It would select equipment on the basis of cost and features rather than board room direction. There would be no cross subsidies to or from Long Lines. There would be no cross subsidies to or from Western Electric.

Much of the present debate over rewriting the Communications Act focuses on the perceived need to accommodate AT&T by permitting it to enter competitive markets for telecommunications and data processing equipment. The method proposed above accomplishes this need without subjecting these competitive markets to demonstrable anti-competitive dangers from AT&T's monopoly power. Given AT&T's present structure, or that proposed by Senate Bill 898, there is no likelihood that the FCC could control AT&T's anti-competitive activity. Such activity is well documented in the twenty or so antitrust cases both public and private pending around the country as well as in the pretrial materials which preceded Bell's settlement of cases such as Datran where AT&T paid 50 million dollars to settle antitrust and unfair competition claims.

Datapoint opposes the enactment of Senate Bill 898 because if fails to alter AT&T's incentive to confer unfair advantage on the competitive affiliate envisioned by the Bill. As the FCC recognized in the Second Computer Inquiry, "If (the AT&T monopoly) has an incentive to exercise its market power to the disadvantage of consumers and competitors in the absence of a separate subsidiary, it has the same incentive to do so after one is required." AT&T's incentive to assist a competitive affiliate will be substantial. Competition in the data processing and telecommunications market is fierce. It is folly to believe that AT&T will forego any opportunity to improve its position by resorting to its monopoly resources.

Under Senate Bill 898, not only will AT&T have the incentive to offer anti-competitive assistance to its affiliate, it will also have the opportunity both during and after the eight-year transition period. During the transition period, when products destined for the competitive market are manufactured and developed by AT&T's monopoly affiliates Western Electric and Bell Labs, the thrust of Senate Bill 898 is to rely on accounting controls and requirements for "arms-length dealing" and "fully auditable and compensatory" transfers. Such safeguards are illusory.

The FCC has never been able to impose effective accounting controls on AT&T, and it is wholly unrealistic to expect that such controls can be placed upon a corporation of its size, particularly where that corporation has a significant incentive to avoid such controls. The eight-year transition period is particularly anomalous in a market where new products are typically brought from the drawing board to production in eighteen months and product lives are typically only five to seven years. I suspect that it is no accident that Senate Bill 898 is not enforceable. If I were the Chief Executive Officer of AT&T, I would have wanted the Bill written that way too.

The controls proposed by Senate Bill 898 won't work. For example, in May of 1980, AT&T with the active assistance of its subsidiary, Southwestern Bell, decided to conduct an electronic information service (EIS) trial in Austin, Texas. This trial involved placing terminals in residences and businesses to permit individuals to access a remote database containing such information as the white and yellow pages, updated advertising and news. Datapoint, along with the Texas Daily Newspaper Association and Tandy Corporation, challenged AT&T's EIS operation before the Texas Public Utility Commission on the basis that Southwestern Bell was granting anti-competitive assistance to the development of a competitive product that, under the FCC's Second Computer Inquiry decision, AT&T would have to offer through a separate subsidiary. Evidence gathered in that regulatory proceeding indicates that AT&T was obtaining at least the following assistance from its wholly owned monopoly affiliate: (a) management expertise, (b) directory sales assistance, (c) access to white and yellow pages in electronic form, (d) credit information on prospective trial participants, (e) priority installation of intercity private line facilities, and (f) priority maintenance for those facilities. No competitor could have obtained such assistance. Ostensibly, Southwestern Bell was accounting for the cost of that assistance and charging these costs to AT&T which it would then charge its fully separated subsidiary. However, how does one allocate management expertise or priority installation of private line facilities or priority maintenance. Moreover, while AT&T insisted on calling this activity research and development, it is very apparent that this was not research and development but rather the first stage in marketing an EIS system, a marketing function that properly should have been performed through a separate subsidiary under the Second Computer Inquiry decision and which would be performed by the subsidiary envisioned by Senate Bill 898. The cross subsidies that AT&T's monopoly operations were providing to the development and marketing of a competitive product could have occurred under Senate Bill 898. Indeed immediately before Senate Bill 898 with its new newspaper protection provisions was voted out of The Senate Commerce Committee, Bell announced abandonment of its EIS II "experiment".

In the area of financing, under Senate Bill 898, the competitive affiliate will have preferential access to the bond markets by reason of its association with the AT&T monopoly. This preference stems from AT&T's overwhelming financial strength which in turn is provided by their public monopoly. Also, during the transition period, the bulk of the cash and assets that normally would be required to start up a business on the scale of the competitive affiliate will remain with the parent monopoly, allowing the affiliate to show significant profits on relatively modest sales.

It must be recognized that whatever the desire of the proponents of Senate Bill 898 to create a stand-alone competitive affiliate, the goal of the entire Bell system -- from upper management to the telephone account executive -- will be to lend assistance to the competitive affiliate. Such favoritism cannot be avoided by the pronouncements in Senate Bill 898, and amounts to the transfer of an unfair competitive advantage from AT&T's monopoly operations to its competitive affiliate.

Senate Bill 898 is a prescription for stagnation in the telecommunications marketplace. AT&T's low level of innovation results primarily from its commercial desire to protect its installed equipment base. Bringing forth new and innovative products as a means of meeting competition is a risky undertaking. A much less risky means of meeting competition is to underprice an existing product line to encourage consumers to keep outdated, underpriced equipment. An AT&T affiliate, however, would possess by reason of its association with the AT&T monopoly, access to monopoly revenues as a means of underpricing and defeating competition in any market that they wish to enter. Of course, such a "lower-cost" option for the consumer would be available only until competition was eliminated.

The proponents of Senate Bill 898 also argue that introducing AT&T into the competitive data processing and telecommunications markets will permit it to actively market a full range of computerized information systems overseas and, thereby, strengthen the United States' competitive position. No legitimate support exists for that theory. Currently, Datapoint derives fully 20% of its revenues from exporting products. Approximately 40% of our U.S. manufactured products are shipped to customers outside the U.S. One of the few bright spots in the United States' otherwise bleak balance of trade situation is the data processing industry. It is entrepreneurs like Datapoint who have shown success in the international market, and that success should not be endangered. If as I proposed, it is "AT&T - Western Electric" that enters the export market, and if it is successful, the U.S. balance of trade would truly be helped. However, if it is a fully subsidized affiliate as is proposed by Senate Bill 898, it is likely that AT&T's monopoly ratepayers will subsidize the competitive offerings of its affiliate to enable it to meet government-subsidized competition from foreign competitors.

The option of divestiture has received little scrutiny in relation to the Communications Act rewrite efforts in this Congressional session and the last. Whenever my staff or I inquired into the possibilities of divestiture, the response we received was that divestiture was not politically possible. The Department of Defense is concerned that without network coordination readily available in a time of national stress, telecommunications could be interrupted. It seems to me that the national interest requires recognition of this concern and a response more secure than mere delegation of the problem to AT&T. When we asked, aside from political considerations, is divestiture the proper remedy, the one which is best for the country, those who responded directly stated that it was. We urge this Congress to draft legislation which provides for the divestiture of AT&T as outlined.

Respectfully submitted,

Harold E. O'Kelley
President, Chief Executive
Officer and Chairman of the
Board

Enclosures:

a) Statement to the Subcommittee on Telecommunications, Consume Protection, and Finance of the Committee on Energy and Commerce of the U. S. House of Representatives concerning Competition and Deregulation in the Telecommunications Industry.

b) Statement to the Defense Communications Administration.

TESTIMONY OF

WILLIAM G. MCGOWAN
CHAIRMAN OF THE BOARD
MCI COMMUNICATIONS CORPORATION

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I AM WILLIAM G. MCGOWAN, CHAIRMAN OF THE BOARD OF MCI COMMUNICATIONS CORPORATION.

HEARINGS SUCH AS THIS ARE VERY IMPORTANT TO THE PEOPLE OF THIS COUNTRY. THEY CAN REMIND US OF WHAT THE ANTITRUST LAWS ARE FOR -- AND DISPEL THE MYTHS GENERATED BY THOSE WHO SEEK TO UNDERCUT THEM.

ADDITIONALLY, IN EXAMINING MONOPOLIZATION OF THE TELECOMMUNICATIONS INDUSTRY, IT IS CLEAR THAT THE ANTITRUST LAWS ARE NO MERE THEORETICAL EXERCISE, BUT ARE VITALLY NEEDED CONSTRAINTS ON CLEAR, ON-GOING, AND ARROGANT ABUSE OF THE PUBLIC'S ECONOMIC WELL-BEING.

WHAT DO WE HEAR BEING SAID AGAINST THESE LAWS?

WE HEAR THAT THEY CONDEMN "BIGNESS," AND THAT "BIGNESS ISN'T NECESSARILY BAD." THIS IS A STRAW MAN. THE LAWS DO NOT OUTLAW BIGNESS, BUT ONLY ATTEMPT TO MONOPOLIZE A MARKET, WHETHER BY LARGE OR SMALL COMPANIES.

WE HEAR THAT THE ANTITRUST LAWS ARE "ANTI-BUSINESS." THEY ARE NOT. THEY AIM TO PROTECT THE PEOPLE, YES, BUT BY PRESERVING A COMPETITIVE MARKETPLACE IN WHICH COMPANIES CAN SUCCEED ONLY BY WINNING THE PEOPLE'S APPROVAL. BECAUSE THE LAWS TAKE THIS APPROACH, THEY FUNDAMENTALLY SUPPORT THE FREE-ENTERPRISE, FREE MARKET WORLD IN WHICH BUSINESS THRIVES. WHEN THE ANTITRUST LAWS ARE ENFORCED, CONSUMERS AND HONEST BUSINESSMEN ARE EQUALLY THE BENEFICIARIES.

ENFORCEMENT OF THESE LAWS IS THUS PRO-BUSINESS. THE FAILURE TO ENFORCE THEM DISCOURAGES BUSINESS INVESTMENT AND ENTREPRENEURIAL EFFORT.

I AM A BUSINESSMAN, AND I AGREE WITH WHAT SENATOR JOHN SHERMAN SAID, BACK IN 1890:

> IF WE WILL NOT ENDURE A KING AS A POLITICAL POWER

> WE SHOULD NOT ENDURE A KING OVER THE PRODUCTION, TRANSPORTATION AND SALE OF ANY OF THE NECESSITIES OF LIFE. IF WE WOULD NOT SUBMIT TO AN EMPEROR, WE SHOULD NOT SUBMIT TO AN AUTOCRAT OF TRADE, WITH POWER TO PREVENT COMPETITION AND TO FIX THE PRICE OF ANY COMMODITY.

I BELIEVE THAT IF SENATOR SHERMAN WERE TO MAKE THESE POINTS ON THE FLOOR OF THE SENATE THIS AFTERNOON, HE WOULD IMMEDIATELY TAKE THE EXAMPLE OF THE AMERICAN TELEPHONE AND TELEGRAPH COMPANY AND SAY "THERE! THAT IS EXACTLY WHAT I MEAN!"

MCI HAS HAD LONG AND BITTER EXPERIENCE WITH AT&T, AND BECAUSE OF EVENTS NOW TRANSPIRING IN THIS CONGRESS, WE ARE LIKELY TO HAVE MORE YET. AT&T IS MARSHALLING POLITICAL POWER BEHIND ITS DEMONSTRATED INTENT NOT TO COMPETE FAIRLY IN A FREE MARKET.

MCI IS A SMALL COMPANY, RELATIVE TO THE TELECOMMUNICATIONS MARKET, WITH REVENUES LAST YEAR OF $234 MILLION. WE COMPETE DIRECTLY WITH AT&T IN THE PROVISION OF LONG DISTANCE TELEPHONE SERVICE. AFTER A PLANT INVESTMENT OF MORE THAN HALF

A BILLION DOLLARS, WE NOW HAVE APPROXIMATELY ONE PERCENT OF THE MARKET.

WE NOW HAVE ABOUT 400,000 CUSTOMERS, THE BULK OF THEM RESIDENTIAL CONSUMERS WHO USE OUR NETWORK AS A LESS EXPENSIVE ALTERNATIVE TO AT&T FOR ORDINARY LONG DISTANCE TELEPHONE CALLS. TO DO THAT, TO GET TO OUR NETWORK, OUR CUSTOMERS MUST PASS THROUGH THE LOCAL, MONOPOLY-FRANCHISE TELEPHONE EXCHANGE OWNED, IN MOST CASES, BY OUR LONG DISTANCE COMPETITOR, AT&T.

THUS, AT&T OWNS THE "ESSENTIAL FACILITY," THE "BOTTLENECK" TO WHICH WE MUST INTERCONNECT IN ORDER TO PROVIDE SERVICE TO OUR CUSTOMERS.

OBVIOUSLY, AT&T CAN DAMAGE US BY LIMITING OUR ACCESS TO CUSTOMERS -- OR BY OVERCHARGING US FOR THAT ACCESS. WHICH ARE THEY DOING? BOTH. AND THEY WANT THE POLITICAL PROCESS TO HELP THEM DO THE LATTER.

ON FRIDAY THE 13TH OF JUNE, 1980, A JURY IN MCI'S FIRST ANTITRUST CASE AGAINST AT&T BROUGHT IN A VERDICT WHICH FOUND AT&T GUILTY OF THE FOLLOWING:

- THREE COUNTS OF DENYING INTERCONNECTION.

- TYING LOCAL SERVICE TO AT&T LONG DISTANCE SERVICE.

- INTERFERING WITH MCI CUSTOMERS BY DISCONNECTING THEM.

- PROVIDING INAPPROPRIATE OR INEFFICIENT EQUIPMENT OR PROCEDURES FOR INTERCONNECTION.

- PREDATORY PRICING.

- PRE-ANNOUNCEMENT OF NEW SERVICE.

- NEGOTIATING IN BAD FAITH FOR AN INTERCONNECTION AGREEMENT.

- FILING STATE TARIFFS IN BAD FAITH.

I AM ATTACHING, AS PART OF MY TESTIMONY, THE SPECIAL VERDICT BROUGHT IN BY THE JURY, AND THE TABLE OF CONTENTS FROM A SELECTION OF THE DOCUMENTS PUT INTO EVIDENCE. THE SELECTION OF DOCUMENTS ITSELF IS PROVIDED SEPARATELY, SINCE IT IS VOLUMINOUS.

THIS WAS MCI'S SUIT. SCORES OF OTHERS HAVE BEEN FILED AGAINST AT&T BY OTHER BUSINESSMEN SEEKING RESTITUTION UNDER THE LAW. THE GOVERNMENT HAS JUST RESTED ITS CASE AGAINST BELL, AND IS ASKING THE COURT TO PUT A STOP TO AT&T'S TACTICS ONCE AND FOR ALL. OF THE CASES WHICH HAVE BEEN CONCLUDED, AT&T HAS EITHER SETTLED OR LOST MOST OF THEM.

NOW, BELL'S EXECUTIVES ARE SAYING THEIR ATTITUDE HAS CHANGED. THEY CLAIM TO ACCEPT COMPETITION. THEY JUST WANT A LAW TO MAKE COMPETITION "FAIR" TO THEM.

DON'T BELIEVE IT.

THESE ARE THE SAME PEOPLE WHOSE CONTRARY INTENTIONS HAVE BEEN AMPLY DEMONSTRATED. AT A 1972 CONFERENCE IN KEY LARGO, FLORIDA, WHERE AT&T'S TOP EXECUTIVES MET TO DECIDE

STRATEGY TOWARDS MCI, ONE OF THE OPERATING COMPANY PRESIDENTS COUNSELLED THAT THERE WAS A "LARGE AMOUNT OF REVENUES VULNERABLE WHICH WE CAN PRESERVE IF WE CHOKE OFF NOW."

THAT WAS MR. CHARLES BROWN, WHO IS NOW CHAIRMAN OF THE BOARD OF AT&T.

WHEN ANTITRUST ACTION SEEMED LIKELY, AN INTERNAL AT&T MEMO WENT FROM F. F. STODDARD TO W. W. BETTERIDGE, WHICH SAID IN PART:

> AS DISCUSSED, WE HAVE BEEN MOVING TOWARD REVIEWING AND CLEANING OUT OUR FILES.
>
> A SHREDDER IS AVAILABLE AND IS IN USE.
>
> MR. SHULTZ AND I HAVE MET WITH THE LAWYERS AND MODIFIED OUR EXISTING REPORTS, AS FAR AS, FORMAT, CONTENT, AND DISTRIBUTION.

WHAT DOES THIS SPEAK OF BUT THE DESTRUCTION OF INCRIMINATING DOCUMENTS AND THE "REVISION" OF CONTENT?

AND WHERE IS MR. BETTERIDGE NOW? HE IS IN CHARGE OF AT&T'S NEGOTIATIONS WITH MCI ON THE MANNER AND COST OF OUR INTERCONNECTION TO BELL'S LOCAL MONOPOLY FACILITIES.

IN THOSE NEGOTIATIONS, AT&T HAS PERSISTENTLY REFUSED TO BRING TO THE TABLE ANY COST DATA WHICH WOULD MAKE IT POSSIBLE TO REACH A RATIONAL CONCLUSION ABOUT THE PROPER PRICES FOR VARIOUS FORMS OF INTERCONNECTION.

LET ME POINT OUT THAT THE PENDING LEGISLATION, S.898, WOULD RELY ON THE AVAILABILITY OF ACCURATE ACCOUNTING INFORMATION FROM BELL, TO ENABLE THE FCC TO PREVENT AT&T FROM SUBSIDIZING ITS UNREGULATED COMPETITIVE SERVICES -- IN THE FEW INSTANCES IN WHICH THE FCC WOULD BE PERMITTED TO DO ANYTHING AT ALL.

HAS AT&T REALLY CHANGED, FROM THE COMPANY WHICH, AS SHOWN BY AN EXHIBIT IN MCI'S FIRST ANTITRUST CASE, DECIDED TO TREAT THE ANTITRUST LAWS OF THE COUNTRY "LIKE ANY OTHER BUSINESS RISK?"

LET ME RETURN TO OUR JURY VERDICT. THE JURY FOUND

AT&T GUILTY OF DENYING AND LIMITING INTERCONNECTION, BUT DID NOT FIND IT GUILTY OF OVERPRICING THAT INTERCONNECTION. I DISAGREE WITH THE LATTER FINDING, BUT SINCE THAT TIME AT&T HAS ACTED TO REMOVE ALL DOUBT ABOUT THE MATTER.

NOT ONLY DO THEY STILL REFUSE TO PROVIDE US THE FORM OF INTERCONNECTION WE ARE ENTITLED TO UNDER THE LAW, BUT SINCE OUR CASE WAS FILED THEY HAVE USED THEIR DOMINATION OF THE REGULATORY PROCESS AS A THREAT TO EXACT PAYMENTS FOR ACCESS WHICH ARE FIVE TIMES WHAT THEY HAVE SWORN IN STATE RATE CASES TO BE THE COST OF PROVIDING SUCH FACILITIES.

THE PAYMENTS WE MAKE TO AT&T COMPRISE OUR SINGLE LARGEST COST OF DOING BUSINESS -- MORE THAN WE PAY FOR PERSONNEL, OR OPERATIONS, OR ANYTHING ELSE.

WE WORK UNDER A BURDEN WHICH OBSCURES AND OVERRIDES THE FACT THAT WE HAVE BUILT AND OPERATED OUR SYSTEM MORE EFFICIENTLY THAN AT&T. A COMMON MEASURE OF EFFICIENCY FOR ANY BUSINESS IS THE RATIO OF REVENUES TO EMPLOYEES. IN FISCAL 1981, MCI HAD REVENUES PER EMPLOYEE OF $134,000. THAT CONTRASTS SHARPLY WITH THE $87,000 GENERATED BY THE LONG LINES

DEPARTMENT OF AT&T, A FIGURE WHICH IS UNREALISTICALLY HIGH BECAUSE AT&T HAS SADDLED ITS OPERATING TELEPHONE COMPANIES AND AT&T'S CORPORATE DEPARTMENTS WITH BILLIONS OF DOLLARS IN SUPPORT COSTS WHICH SHOULD BE CHARGED TO ITS LONG DISTANCE OPERATIONS.

WHAT IS THE RESULT? BY OVERCHARGING MCI FOR LOCAL INTERCONNECTION, BELL OFFSETS OUR GREATER EFFICIENCY AND DIMINISHES OUR COMPETITIVENESS AND PROFITABILITY. THIS, IN TURN, INCREASES OUR COST OF CAPITAL.

THE CENTRAL POINT I AM MAKING IS THAT THE MANNER AND COST OF ACCESS TO AT&T'S LOCAL MONOPOLY FACILITIES, BY AT&T'S LONG DISTANCE COMPETITORS, IS AN IMPORTANT ANTITRUST CONCERN. S.898 SHOULD BE EXAMINED FOR ITS IMPACT IN THIS AREA.

OTHER ANTITRUST ASPECTS OF THIS LEGISLATION HAVE BEEN CALLED TO THIS COMMITTEE'S ATTENTION, BUT THEY ARE NOT MORE IMPORTANT THAN THE MATTER OF ACCESS FEES.

A GREAT DEAL HAS BEEN SAID ABOUT S.898'S IMPACT ON THE GOVERNMENT'S ANTITRUST CASE AGAINST BELL. IN ADDITION, YOU

HAVE HEARD WELL-FOUNDED CRITICISMS OF THE SO-CALLED "PROTECTION" OFFERED BELL'S FUTURE COMPETITORS IN INFORMATION SERVICES BY THE "SEPARATE SUBSIDIARY" REQUIREMENTS OF S.898.

YOU HAVE BEEN TOLD, AS WELL, OF THE UNCONSCIONABLE FOLLY OF S.898'S HAVING CONGRESS QUASH THE JUDICIAL DECREE ENTERED IN 1956 AS A RESULT OF THE GOVERNMENT'S PREVIOUS ACTION AGAINST AT&T FOR VIOLATIONS OF THE ANTITRUST LAWS. SUCH AN ACTION WOULD CONSTITUTE A WAIVER, FOR AT&T, OF THE SWIFT TEST THE SUPREME COURT HAS REQUIRED FOR JUDICIAL MODIFICATIONS OF SUCH DECREES. MOREOVER, CONGRESSIONAL INTERFERENCE WITH THE DECREE MUST BE CONSIDERED UNCONSTITUTIONAL. I ASK THAT A MEMORANDUM ON THE CONSTITUTIONAL ISSUE, PREPARED FOR THE HOUSE JUDICIARY COMMITTEE BY THE LAW FIRM OF JENNER & BLOCK, AND A PAPER BY MR. JOEL STILLMAN, BE INCLUDED AS PART OF MY TESTIMONY.

FINALLY, YOU HAVE RIGHTLY BEEN WARNED OF PROPOSALS FOR SUMMARILY DROPPING U.S. V. AT&T ON THE FLIMSY AND PATENTLY FALSE GROUNDS THAT "NATIONAL SECURITY" OR "FOREIGN COMPETITION" SHOULD TAKE PRECEDENCE OVER THE "MERELY TECHNICAL" MATTER OF ANTITRUST LAW ENFORCEMENT.

You are right to be concerned about all this. Especially, any proposal for dropping, or accepting a soft settlement of, the government's antitrust case, and the doubtless unconstitutional interference with the 1956 Consent Decree. Any such actions would have the effect of putting the American Telephone and Telegraph Company above the law.

We are concerned about, and affected by, all these things. I point out that last year the House Judiciary Committee unanimously gave an adverse report to H.R.6121, which was substantially similar to S.898 -- except that the relevant provisions of S.898 are far weaker.

I urge you, however, to interest yourselves as well in the requirements of S.898 relative to the access fees which are to be paid by Bell's tiny long distance competitors for interconnection with the local monopoly telephone companies, whether Bell-owned or independent.

This, too, is an antitrust concern. It involves a classic, textbook, antitrust issue.

IN CONSIDERING THIS ISSUE, TWO FUNDAMENTAL THINGS CANNOT BE IGNORED.

THE FIRST IS THE SUCCESS AT&T AND ITS "INDEPENDENT" TELEPHONE COMPANY PARTNERS HAVE HAD IN BRAINWASHING MEMBERS OF CONGRESS AND THEIR STAFF MEMBERS.

WHILE AT&T'S OWN "COST DATA" -- WHICH THEY HAVE EVERY INCENTIVE TO INFLATE -- SHOW CLEARLY THAT MCI IS BEING GOUGED FOR LOCAL INTERCONNECTION, BELL HAS CARRIED OUT A PUBLIC RELATIONS CAMPAIGN TO CONVINCE THE MEDIA, REGULATORS, AND MEMBERS OF CONGRESS THAT MCI IS PAYING TOO LITTLE FOR EXCHANGE ACCESS AND MUST BE FORCED BY POLITICAL ACTION TO PAY MORE -- NOT THE 500 PERCENT OF COST THAT IT NOW PAYS, BUT FULLY 1,000 PERCENT OF WHAT FACILITIES IT USES COST THE LOCAL TELEPHONE COMPANY.

THE GIST OF BELL'S CLAIM IS THAT IT USES ITS LONG DISTANCE REVENUES TO SUBSIDIZE "BASIC" LOCAL SERVICE, AND, THEREFORE, THAT COMPETITION IS "UNFAIR" UNLESS MCI IS FORCED TO DO LIKEWISE.

THIS CLAIM IS DEMONSTRABLY PREPOSTEROUS. HOWEVER, MANY CONGRESSMEN HAVE REPEATED THIS CLAIM AS IF IT WERE FACT, AND S.898 BRISTLES WITH LANGUAGE WHICH SAYS THAT THE SETTING OF ACCESS FEES MUST NOT RESULT IN UNREASONABLE INCREASES FOR "BASIC" SERVICE.

"BASIC SERVICE," BY THE WAY, IS DEFINED IN S.898 AS LOCAL SERVICE AND THE TELEPHONE-COMPANY'S LONG DISTANCE SERVICE WITH WHICH WE COMPETE. THE BILL PROVIDES FOR SURCHARGES TO BE APPLIED ON TOP OF ACCESS FEES TO SUBSIDIZE SUCH "BASIC SERVICE."

SOMEONE HAS GOT TO INJECT A NOTE OF SANITY IN ALL THIS. YOU ARE IN A POSITION TO DO SO BECAUSE, WITH YOUR COMMITTEE'S EXPERTISE, YOU CAN RECOGNIZE BELL'S PLOY FOR WHAT IT IS: AN ATTEMPT TO USE A WELL-MEANING CONGRESS TO RATIONALIZE AND JUSTIFY A CLASSIC ANTITRUST OFFENSE, USING THE CONTROL OF ESSENTIAL FACILITIES IN ONE MARKET TO HARM COMPETITORS IN ANOTHER.

THE SECOND THING WHICH SHOULD BE REALIZED IS THAT S.898 WILL NOT TAKE EFFECT IN A VACUUM OF EVENTS, BUT IN A

COMPLEX ENVIRONMENT. NOR SHOULD YOU FORGET THAT AT&T CONTROLS THOSE EVENTS.

A KEY PROVISION OF S.898 [SEC. 222(C)] REMOVES THE MOST IMPORTANT ELEMENT OF THE FCC'S CONTROL OVER THE ESTABLISHMENT OF ACCESS FEES FOR ACCESS BY INTERSTATE CARRIERS TO LOCAL EXCHANGE FACILITIES.

THE ALLOCATION OF LOCAL EXCHANGE PLANT COSTS TO INTERCITY CARRIERS INTERCONNECTING WITH LOCAL SYSTEMS IS TO BE DONE BY A JOINT BOARD, WHICH HAS FCC MEMBERS, BUT WHOSE MAJORITY IS TO BE NOMINATED BY A PROFESSIONAL ASSOCIATION REPRESENTING STATE UTILITIES COMMISSIONERS.

WHAT WILL BE THEIR MOTIVATION? TO LOAD COSTS ON THAT PART OF TELEPHONE OPERATIONS FOR WHICH THE FCC IS RESPONSIBLE -- IN OTHER WORDS, ON INTERCITY CARRIERS AND THEIR CUSTOMERS.

WHY WOULD THEY DO THIS? BECAUSE AT&T IS GIVING THEM EVERY INCENTIVE TO DO SO. BELL IS NOW SEEKING OUTRAGEOUS LOCAL RATE INCREASES FROM STATE COMMISSIONS NATIONWIDE, WITH WHAT CAN ONLY BE CHARACTERIZED AS A FEEDING FRENZY.

In 1980, Bell suddenly more than quadrupled the rate increases demanded in local areas. Between 1975 and 1979, Bell sought between $500 million and $1 billion each year from state commissions. In 1980, AT&T went in for $4,500,000,000. Applications filed so far in 1981 indicate they will far exceed that level this year. They are hitting the state commissions with rate increase requests twice a year, instead of every two years or so.

Thus, Bell is, right now, provoking the sort of reaction by state commissioners which will be most detrimental to its long distance competitors: a joint board overallocation of costs to interexchange services, resulting in excessive charges for access to local exchanges.

Obviously, only AT&T can stand such an overallocation, because it can recover the money through its own local subsidiaries, and remain in a position to offset such costs, insofar as its long distance rates are concerned, by undercompensating those subsidiaries for facilities and services they render to Long Lines.

BELL'S COMPETITORS WOULD WATCH THEIR ACCESS PAYMENTS VANISH INTO THE HIDDEN WORLD OF INTERNAL AT&T TRANSFERS OF MONEY, FACILITIES, AND SERVICES. BUT BELL FOR THE MOST PART, WOULD SIMPLY "PAY" ITSELF BY TRANSFERRING FUNDS FROM ONE CORPORATE POCKET TO ANOTHER.

SO. THE PR JOB HAS BEEN DONE. THE REGULATORY PRESSURES ARE RAPIDLY BEING BUILT UP. IF S.898 BECOMES LAW, IT WILL PUT IN PLACE THE MECHANISM FOR A FUNDAMENTALLY ANTICOMPETITIVE OUTCOME.

S.898 MAKES THE COST ALLOCATION PERFORMED BY THE JOINT BOARD BINDING ON THE FCC UNLESS IT IS "ARBITRARY AND CAPRICIOUS" OR OTHERWISE INCONSISTENT WITH THE PURPOSES OF THE BILL.

THAT PUTS THE BURDEN IN THE WRONG PLACE. THE BURDEN SHOULD BE ON THE BOARD AND THE FCC TO EXAMINE THE PATTERN OF BELL'S LOCAL RATE DEMANDS, AND ASSIGN COSTS ON THE BASIS OF ACTUAL COST CAUSATION. WITH A PROPER EVIDENTIARY HEARING, AN ENTIRELY DIFFERENT, PRO-COMPETITIVE OUTCOME COULD RESULT:

1. LOCAL RATE INCREASES COULD BE AVOIDED WHERE NOT NECESSARY -- AND THERE IS PLENTY OF EVIDENCE THAT LOCAL RATES ARE ALREADY HIGH ENOUGH.

2. COST-BASED ACCESS CHARGES COULD BE PUT IN PLACE.

3. AT&T COULD BE FORCED TO CONFRONT ITS GROSS INEFFICIENCY AND CORRECT IT IN ORDER TO MEET COMPETITION IN A WAY BENEFICIAL TO CONSUMERS.

WHAT IS THE ALTERNATIVE? HIGH -- EGGREGIOUSLY HIGH -- RATES FOR LOCAL EXCHANGE SERVICE, IN WHICH AT&T HAS A COMPLETE MONOPOLY IN ITS SERVICE AREAS, WHICH INCLUDE 82% OF THE COUNTRY'S TELEPHONES; FRANTIC ATTEMPTS BY STATE REGULATORS TO SHIFT COSTS TO THE FCC'S JURISDICTION; AND, ALL IN ALL, A THOROUGHGOING MESS MADE OF THE TELECOMMUNICATIONS INDUSTRY, WITH LONG DISTANCE COMPETITION BEING SACRIFICED TO BELL-PROVOKED PANIC.

THIS IS NO FAR-FETCHED SCENARIO. THE PAST BEHAVIOR OF

MANY STATE COMMISSIONERS, BELL'S AGGRESSIVE RATE DEMANDS, AND THE SORRY HISTORY OF JOINT BOARDS -- ALL TESTIFY TO THE REALITY OF WHAT IS HAPPENING.

THESE ARE NO DRY AND ABSTRACT CONCERNS. EVERY AMERICAN FAMILY IS BEING AFFECTED RIGHT NOW. THEY ARE BEING HIT WHERE MONOPOLISTS ALWAYS HIT THEIR CUSTOMERS, IN THE POCKETBOOK.

WHERE IS THE OUTCRY COMING FROM AGAINST THIS LEGISLATION, AGAINST THESE ATTEMPTS TO MAKE THE ANTITRUST LAWS A NULLITY FOR THE WORLD'S LARGEST, MOST POWERFUL CORPORATION?

IT IS COMING FROM BUSINESSMEN WHO ARE BEING DAMAGED -- SOME OF WHOM HAVE BEEN BANKRUPTED -- WHO NOW FACE, OR WILL FACE, A CORPORATION WHICH IS NOT A FAIR COMPETITOR BUT A PROVEN PREDATOR -- SOON TO BE ARMED WITH DISGRACEFULLY ONE-SIDED SPECIAL INTEREST LEGISLATION.

BUT WE BUSINESSMEN WILL NOT BE ALONE. WITH DOUBLED AND TRIPLED LOCAL RATES, WITH NO REAL CHOICE IN LONG DISTANCE

SERVICE, THE PUBLIC, THE USERS OF COMMUNICATION, ARE WAKING UP. IN THE YEARS AHEAD, SUPPORT OF THIS LEGISLATION IS BOUND TO BECOME A POLITICAL LIABILITY.

I ASK YOU TO EXAMINE VERY CAREFULLY THIS MATTER OF LOCAL ACCESS FEES. YOU MAY DECIDE THE COMPETITIVE HEALTH OF WHAT, BY 1985, WILL BE A $65 BILLION LONG DISTANCE INDUSTRY.

THIS COMMITTEE IS BETTER PLACED THAN ANY OTHER TO UNDERSTAND WHAT IS HAPPENING HERE: THAT AT&T IS CREATING AN EXCUSE AND A JUSTIFICATION FOR THE CLASSIC PREDICTABLE BEHAVIOR OF A MONOPOLIST.

Senator **Grassley**. It is my pleasure now to call to the witness table Herbert N. Jasper and Nina Cornell.

Mr. Jasper is executive vice president of the Ad Hoc Committee for Competitive Telecommunications. ACCT is a nonprofit industry association organized in 1976 in response to the consideration of telecommunication legislation then pending before Congress. ACCT represents nine companies offering a variety of long-distance services.

Dr. Cornell holds a Ph. D. in economics from the University of Illinois. She has worked for the Brookings Institution, the Council on Wage and Price Stability, and was on the staff of the Council of Economic Advisers. Most recently, she was chief of the FCC's Office of Plans and Policy. Currently, she is a partner in the economic consulting firm of Owen, Cornell, Greenhalgh, and Myslinski.

Welcome to the witness table and the committee meeting. Even though other members of the committee are not here because of the tax bill being on the floor of the Senate, I hope you realize your testimony will be reviewed by those other committee members and staff in our determination of any antitrust implications of this particular piece of legislation before it goes to the floor. It is now presently before the Senate because it was favorably reported out of the Commerce Committee.

At this point, I would like to turn to Mr. Jasper and then Dr. Cornell for testimony. Please proceed.

STATEMENT OF HERBERT N. JASPER, EXECUTIVE VICE PRESIDENT, AD HOC COMMITTEE FOR COMPETITIVE TELECOMMUNICATIONS, WASHINGTON, D.C.

Mr. **Jasper**. Thank you very much, Mr. Chairman. As a former Senate staffer, I am fully familiar with the scheduling difficulties to which you referred. No explanations or apologies are necessary in my case.

I want to express our appreciation that the Judiciary Committee has given us this opportunity to testify on the authority, control, and oversight needed to sustain full and fair competition.

We are alarmed at the threat to the emerging competitive environment posed by S. 898. That bill would deregulate certain A.T. & T. offerings prematurely, strip the FCC of vital powers it now possesses, attempt to set aside a judicial decree in a possibly unconstitutional manner, and undermine antitrust policy.

While the bill recognizes that restructuring A.T. & T. is absolutely essential, it relies on a so-called fully separated subsidiary, which—to put it charitably—is a sham.

THE EVOLUTION OF ANTICOMPETITIVE LEGISLATION: S. 898

S. 898 embodies Bell's own proposals for industry restructuring and deregulation. To enact Bell's legislative proposals would be to reward predatory conduct by making it lawful. The FCC would completely lack the authority and control needed to prevent Bell's continued and even aggravated, anticompetitive behavior.

Bell's very success in securing the introduction and committee approval of its anticompetitive proposals—under the guise of fostering competition—should be cause for alarm about the insidious power of this firm. The Packwood bill is procompetitive only in its policy declarations. It would give Bell a license to wipe out the fledging competition.

The fundamental structure of the bill is derived directly from Bell's proposals. That is, certain services and terminal equipment are to be offered by it on an unregulated basis. Protection from anticompetitive and unlawful behavior is to be achieved solely by reliance on a wholly owned, separate subsidiary whose transactions with Bell would require legions of new FCC personnel to oversee. A joint board having a majority of State members would be given certain, vital FCC powers.

Bell, of course, has more of everything than its new competitors and more data about the industry. As a consequence, it can shape the issues; control what information regulators and legislators receive; enlist State officials, independent telephone companies, and employee unions to advance its cause; and delay progress in regulatory and judicial proceedings while it seeks to subvert them by legislative intervention.

The reason Bell prefers the congressional forum is obvious: its competitors are insured due process and essentially equal time in the other fora. In the Congress, however, Bell and its few influential supporters can drown out the competitors' voices. That is why the almost universal complaints of users and actual competitors, as well as those of the FCC, were generally ignored by the Commerce Committee.

SUMMARY OF POSITIONS OF INTERESTED PARTIES ON S. 898

Almost all those who now compete with Bell—and virtually all user spokespersons—oppose the major provisions of the bill; not because they fear continued competition with Bell but because the bill would enlarge Bell's opportunities to behave anticompetitively.

A number of significant changes were proposed in the bill by users and competitors. These included proposals that there be more than two affiliates; that more stringent separation be required; and that the FCC's existing authorities be preserved or strengthened. Although the reported bill does make some improvements, none of the foregoing changes was made. Some changes exacerbated existing problems in the bill.

BELL REWARDED FOR ANTICOMPETITIVE RECORD

Bell's anticompetitive tactics have drastically limited the competitors' opportunities, driven some of them out of the marketplace, and discouraged countless others from entry. For example, A.T. & T. has consistently fought competitors with anticompetitive and unlawful rates and practices. As a result, it is the defendant in more than 30 private antitrust suits.

It has destroyed relevant documents in antitrust cases. It has been found in significant violation of the antitrust laws after trial in three private suits. It has recently settled three other private suits by agreeing to revise certain practices and to make large payments or advances.

It is a defendant in a Federal suit alleging a wide variety of unlawful practices, affecting virtually every segment of the industry. It exploits its discrimination in interconnection, which Mr. McGowan discussed, by warning customers about the inconvenience of the 22-digit dialing required to use the competitor's services.

Its then-chairman of the board appeared in the introduction to a training film which advises Bell employees that they can avoid embarrassment if they are prudent in destroying files.

Under S. 898, even without electronic publishing or alarm and cable TV services, Bell is a clear winner. In return for the three exclusions, Bell would have the 1956 consent decree set aside so that it could enter the computer and data processing industries, among others. These are multibillion dollar industries. Despite its overwhelming dominance, 20 percent or more of its business would be deregulated under the bill.

ANTITRUST ISSUES TO BE CONSIDERED IN EVALUATING PENDING LEGISLATION

If the bill were enacted, it would be the first time in the history of our Republic that the Congress accepted, let alone directed, the creation of a conglomerate corporate entity with overwhelming market dominance in various product and service lines. This conglomerate would be deregulated.

To presume that deregulation will strengthen the miniscule competition which has emerged under existing law is to presume that A.T. & T. is voluntarily prepared to compete fairly. The public deserves more meaningful protection against the possibility of continued anticompetitive and predatory practices by Bell than the mere assertion by its management that they plan to compete fairly. The pending legislation fails to provide such assurance because it authorizes Bell to operate through its new unregulated conglomerate subsidiary without any oversight by the FCC.

Some assert that legislation is so badly needed that we cannot wait for the courts to rule on relief necessitated by A.T. & T.'s alleged violations of the antitrust laws. However, the bill would make only two significant changes which are beyond the power of FCC to accomplish under existing legislation. One of those could be accomplished in a one-sentence bill. Clearly, there is nothing in the bill which warrants its enactment in spite of its serious flaws.

Proponents have also contended that the bill is needed to prevent the courts from establishing national telecommunications policy. However, the Federal antitrust suit is based on A.T. & T.'s own behavior. The court is merely being asked to determine whether the Government's charges are substantiated, and, if so, to prescribe appropriate relief which would prevent the repetition of unlawful conduct. Thus, the court is considering the effectuation of congressional antitrust policy.

In testimony on S. 898, former judge and Attorney General Griffin Bell stated that the Congress was better equipped than a district judge to fashion any relief which may be required in the case. Yet he stated that it was appropriate for the Justice Department to bring a monopoly suit and for a Federal court to decide that it was a prohibited monopoly. In other words, the court could determine liability.

However, he was not asked by the Commerce Committee of what consequence a finding of liability against A.T. & T. would be if the Congress had already chosen a remedy in ignorance of that liability.

We take no position on the desirability of having Bell now enter markets from which it proposed to exclude itself by the 1956 consent decree. However, in last year's adverse report on H.R. 6121 by the House Judiciary Committee, it was noted that some witnesses had suggested that the means chosen for congressional modification of the decree was unconstitutional. The argument was that the court which entered the decree was interpreting the requirements of the antitrust laws. Congress could not lawfully modify the court's interpretation, except by changing the underlying antitrust statutes or exempting a party from their application.

Because the bill's antitrust savings clause stated that the antitrust statutes and their applicability were not to be changed, the consent decree provision would, thus, be an unconstitutional attempt by Congress to perform a judicial act; that is, to modify the 1956 decree. It was also suggested that the legislation might be an impermissible encroachment on the executive power as well.

To expect that it will be possible adequately to separate costs in the joint use of facilities by the Bell entities providing basic and nonbasic services is completely unrealistic. The burden that it would place on the FCC to police such cost allocations would be overwhelming.

The new A.T. & T. subsidiary would be by no means fully separated from its parent. Baby Bell would be entirely under the control of Ma Bell. Both would have undiminished incentives to assist each other in achieving Bell's overall corporate objectives. A.T. & T.'s own president has publicly announced that such is their intention.

Bell could share its immense tax advantages and favorable borrowing opportunities with the new subsidiary. The affiliate could engage in joint ventures and partnerships with the parent or other affiliates. It could jointly use facilities, use the corporate logo, and enjoy the benefits of joint institutional advertising.

The provisions for separation fall far short of those which have been mandated by the FCC in other cases, including SBS and GTE Telenet, which are members of our association. Surely, there can be no valid reason to apply lesser separation requirements to a company with A.T. & T.'s egregious anticompetitive record.

The conglomerate subsidiary would have overwhelming dominance in two telecommunications markets. The legislation would also deregulate those offerings, evidently on the belief that the mere creation of a new wholly owned subsidiary would make anticompetitive behavior impossible.

In 1977, we commissioned a study by Arthur D. Little, Inc., of the concept of a separate subsidiary for A.T. & T.'s competitive interexchange services. ADL concluded that establishment of such a subsidiary, although fully subject to FCC regulation, would "reduce opportunities only to a limited extent and would not affect incentives for cross-subsidization."

While ADL concluded that the creation of a subsidiary "would improve the efficacy of FCC regulation, it would not reduce the degree of the Commission's involvement in the competitive marketplace." In other words, assuring full and fair competition would require continued FCC authority over, and intensive involvement in, the practices and pricing of the subsidiary. S. 898, however, would revoke such authority.

ADL also observed "that the potential would remain for A.T. & T. to confer unfair advantage upon the subsidiary. * * *" Their report considered whether third-party oversight could help to assure the fairness and visibility of transaction. However, in each case, ADL found that such oversight "would be of little assistance," and concluded that "neither underwriting nor auditing procedures could be expected to provide any assurance that investment capital was not being diverted from the enhancement of exchange and toll service to finance more marginal investments in nonmonopoly business."

This conclusion is highly relevant to an assessment of S. 898, for the bill provides in section 229(d)(1), that "services or equipment * * * shall be furnished to any fully separated affiliate for an amount which is fully compensatory and * * * no less than the charges for which similar services and equipment would be or are transferred in the marketplace between nonaffiliates. * * *"

In contrast, ADL quoted from the standards of the CPA's Institute regarding "related party transactions," that "representations to the effect that a transaction was consummated on terms no less favorable than those that would have been obtained if the transaction had been with an unrelated party are difficult to substantiate."

Finally, ADL stated with respect to the incentive structure, stockholders' benefits, and an evaluation of management performance that, "* * * a wholly owned subsidiary is not more separate than a division or branch. The incentive will be to cross-subsidize * * * as long as it results in the maximization of combined earnings and containment of competitors."

The separate subsidiary under the bill differs from that reviewed in the study in two principal ways: it would be a $15 to $20 billion conglomerate operating in three major markets; it would be unregulated, and the FCC's existing powers, including those over the affiliate's transactions with A.T. & T., would be drastically reduced.

Thus, the legislation would offer no meaningful protection to the emerging competitive industry. Rather, it would reward Bell for an unparalleled record of anticompetitive behavior by freeing it from the restraints of the regulatory process.

FCC AUTHORITY IS TOTALLY INADEQUATE

Although the FCC would be limited to policing transactions between the parent and its deregulated subsidiary, the bill would take away vital powers from the FCC over those dealings. Existing law provides for Federal/State joint boards which are advisory. The bill, however, would vest crucial functions in such a joint board and make their decisions binding on the FCC.

In addition, the bill would create an assets evaluation board to perform essential functions now vested in the FCC. The board would rule on the value of assets assigned to the new subsidiary by

A.T. & T. Its composition would guarantee that A.T. & T. would determine the outcome of its proceedings.

We have shown in my prepared statement how A.T. & T. could exploit S. 898 to thwart competitors' interexchange services with the acquiescence of the assets evaluation board and the joint board.

CONCLUSION

Mr. Chairman, the extraordinary power of A.T. & T. has created a "rush to judgment." In testifying on S. 898, Secretary of Commerce Baldrige urged that all parties should be heard on this complex and vital matter. Yet while generally supporting the "thrust of the legislation," he had not himself heard from many vitally interested consumer groups or competitive suppliers who opposed major features of the bill. Nor did the Commerce Committee.

The exclusion of Bell from electronic publications, cable TV, and alarm services demonstrates that the Commerce Committee, itself, has no faith in the "safeguards" afforded by the separate subsidiary approach.

The bill would undermine the authority of the Department of Justice for antitrust enforcement, as well as that of the FCC for effectuation of communications policy. FCC Chairman Fowler has asked for preservation of FCC authority regarding A.T. & T.'s conduct and structure, and regarding access charges. The Commerce Committee asserts that the bill relies on the FCC to assure that unfair competition will not take place. One has to ask why the committee, then, rejected most of the entirely reasonable amendments proposed by the FCC, as well as those by users and actual competitors of A.T. & T.

We urge that this committee insist that the Senate afford "due process" to those who have already accepted the challenge of competing with A.T. & T.—and to their customers. Against great odds, they have invested more than $1 billion in these ventures. If the rules are to be dramatically changed, surely there ought to be ample opportunity to hear and to carefully consider all of the legitimate questions, criticisms, and proposed amendments which legislation of this scope inevitably brings forth. The Commerce Committee has refused to do that.

Thank you very much.

Senator **Grassley**. Thank you.

In my judgment, we should continue with your testimony even though I have to go vote. We have a senior staffer here who has previously chaired in the absence of Senators when we have been called away for votes. I am going to ask her to take over in my absence. I just hope you do not get upset because we do not give you the attention you probably deserve.

Ms. Cornell, please proceed with your testimony.

STATEMENT OF NINA W. CORNELL, OWEN, CORNELL, GREENHALGH & MYSLINSKI, ECONOMISTS, INC., WASHINGTON, D.C.

Dr. **Cornell**. Thank you.

Members of the committee, I appreciate this chance to testify today on the question of whether the new duties that S. 898 would impose upon the FCC can be accomplished by that agency. My unhappy message for you is that the Commission cannot accomplish the goals set for it by this bill.

This conclusion does not rest on any lack of respect for the talents and capabilities of the Commissioners or the staff, but simply on the fact that the tasks assigned to the Commission cannot be accomplished.

THE STRUCTURE OF THE TELECOMMUNICATION MARKET

S. 898 seeks to mix in potentially competitive markets a vertically integrated company, A.T. & T., that has as part of its activities a number of franchise monopoly, rate of return regulated operating companies along with a number of much smaller but crucially unregulated companies that have no incentives to engage in cross-subsidization.

The problem with such a mixture is that in order to offer services at all, the non-A.T. & T. entrance in each of these markets must have access to the local franchised A.T. & T. monopolies on equal terms with A.T. & T.

The bill recognizes that such a mixture is fraught with the potential for anticompetitive behavior by A.T. & T., and so it mandates the use of both fully separated subsidiaries and detailed regulation by the FCC of some of the remaining regulated portions of A.T. & T.

Unfortunately, neither the separate subsidiary approach nor the regulatory powers of the FCC, whether taken separately or combined, is able to control anticompetitive use of the franchised monopoly portions of the system.

Separate subsidiaries, unless so completely separate as to constitute de facto divestiture, do not change in the slightest the incentives of the firm to engage in predatory conduct if it can do so with impunity. It can do so with impunity because the kinds of regulatory activities to prevent such activity specified in the bill are those that, when examined closely, are the kinds of activities no Commission can perform.

A second and important aim of the bill is to reduce the amount of regulation of the telecommunications industry. While it may achieve this goal as applied to other carriers, for A.T. & T. and any other carrier classified as dominant, the bill unambiguously increases the amount of regulation that the FCC will be required to engage in.

The paradox is that if A.T. & T.'s activities were restricted to purely regulated areas, the degree of regulation could be less than this bill calls for. Moreover, the net effect will be to require a significant expansion of the FCC if Congress wanted to have the Agency even attempt to undertake the tasks.

Before elaborating on these two points, it is worth noting an anomaly in the bill itself. In several cases, particularly cable television and electronic advertising, the anticompetitive potential of A.T. & T. is seen as so great as to require banning it from those areas altogether. In other words, the legislation carries in it an inherent acknowledgment that no subsidiary or regulatory oversight can be effective in those markets, despite the fact that they involve activities obviously distinct from simple telephone service.

In short, if subsidiaries and regulations will not prevent anticompetitive behavior in markets that because of their differences from the older telephone service ought to be more easy to oversee, how can they then be viewed as sufficient in telephone markets?

THE FAILINGS OF REGULATION

S. 898 mandates the Commission to oversee A.T. & T.'s cost accounting and cost allocation, its technical operating protocols, and its decisions about technological choices. Unfortunately, S. 898 also seems to ignore the now almost 50-year history of the FCC. These three areas are three areas in which that history has shown a complete inability of any Commission to regulate effectively.

The long series of private line tariffs that have been found to be illegal by the FCC during the 1970's have been rejected in the main not because the FCC examined A.T. & T.'s costs, understood them, and found expenses misallocated, although some of that did occur. The tariffs were found illegal because A.T. & T. could never be made to provide sufficient information of that kind in the first place.

The problem was succinctly described by then Commissioner Kenneth Cox in his separate statement on Telpac in 1964. The Supreme Court action that finally allowed termination of Telpac after the FCC found it unlawful came in 1980; 16 years is a long time for competitors to wait for an end to each separate specific anticompetitive price.

The history of attempts by equipment providers to attach their wares to the Bell system network once the FCC ruled that legal shows how difficult it is for the Commission to deal with extremely simple and only slowly changing operating protocols.

Many observers believe that the technical registration program of part 68 of the Commission's rules has solved this problem after 25 years. Perhaps it has. With the advent of digital technology and more rapid deployment of innovations, ironically induced by competition, however, the protocols may become more complicated and change more rapidly. If that happens, the equipment interconnection problem, viewed as solved today, may not remain solved.

It should be noted, moreover, that nobody believes the problem of anticompetitive use of protocols to prevent competition in services has been solved, as witness the present interconnection disputes between the specialized long distance carriers and A.T. & T., including the one about digits that Mr. McGowan testified to earlier.

To date, all the Commission has been able to do in this area is to suggest that the parties negotiate. Yet such negotiations, if the ENFIA negotiations are any guide, may permit A.T. & T. to force some degree of price fixing on the competitors as the price of access to the local monopolies.

WHY REGULATION FAILS

That these areas should be areas of fairly dramatic if not spectacular failure by the FCC is not due to any lack of talent at the Agency but to the inherent nature of those tasks themselves. To achieve each would require the Commission to acquire vast amounts of information, interpret it, and compare it with alternative possibilities. To understand each alternative, moreover, would also require the acquisition of vast quantities of information. Once all this was completed, preferably rapidly, the Commission would be able to reach a judgment, only to find it had to begin the process over again immediately because the underlying technology had changed, making the old work obsolete.

If the sheer magnitude of data required did not render the task impossible, the problems of actually acquiring the data would. The only place from which to acquire all the necessary information is A.T. & T. itself. Yet if the company willingly and rapidly provides it, and provides it in a manner that anybody can understand, it is potentially giving up its ability to change prices and technical parameters in response to actions by competitors.

As long as the FCC cannot prove anticompetitive behavior, A.T. & T. can continue it and reap the gains from it. Moreover, as the history of the Telpac tariff reveals, powerful groups—Department of Defense, large corporations, and the like—benefit from A.T. & T.'s anticompetitive behavior and use the full extent of the legal system to try to retain those benefits.

The fact that the tasks assigned to the FCC are ones that cannot be carried out successfully is aggravated in S. 898 by the fact that the bill would require the FCC to engage in them much more often than they have in the past. The FCC would acquire oversight over all intrastate toll. The bill would subject many more of A.T. & T.'s activities to cost and technical oversight than ever have been before.

Not only do all of these duties mean expanded, not reduced, regulations, they also will require sizable additions in the budget, personnel, and computer resources, not to mention office space, of the FCC if the agency is even to attempt to accomplish them.

Without being scientific about my estimate, I would not be surprised if the FCC would need another 300 or more people in its common carrier bureau. Similar resources will be needed by the special joint board to determine exchange access charges established by section 222 and by the FCC if it should use the surcharge authority granted in 202(e).

The basic goals that S. 898 seeks, to eliminate the anticompetitive potential of A.T. & T. in order to allow competition and deregulation largely to govern telecommunications, are the right goals to seek. It is the methods of S. 898 that fail. The hard reality is that no regulatory scheme alone can insure that A.T. & T. competes fairly as long as it has both competitive and franchised monopoly components.

Thank you.

Ms. TIFFANY. Dr. Cornell, I do have a few questions for you.

First of all, in your statement and here in your summary, you have mentioned the Commission's technical regulation program. Can you just briefly describe how that program operates and in what way it has eased the equipment interconnection problem?

Dr. CORNELL. I heard only the first part. I can tell you how it operates, and you asked and how it did something and I did not hear you.

Ms. **Tiffany**. How it could ease the equipment interconnection problem?

Dr. **Cornell**. It grew out of the response of Bell to the statement that if other equipment were attached to its network, it could cause technical harm to the network. What was done was to require a series of specifications that basically govern anything that might go back into the network, any signaling, any electrical impulses. I am not an engineer so I will get some of the terms wrong.

However, the effect of it is to set that kind of technical specification that must be met by any equipment that is going to be attached to the network. Once it has been designed and an example of it built, then the Commission looks at it to see whether in fact it meets the specifications. It certifies it. It registers it. Once registered, a label or something is attached, and it can be sold in interstate commerce as meeting that set of specs.

Ms. **Tiffany**. Would the Commission's power and authority to continue this program exist in S. 898?

Dr. **Cornell**. Yes. The problem is right now what A.T. & T. has is a very simple network so it is fairly simple to figure out what kinds of protocols it operates on and to build equipment that works with the network, if you will.

If it becomes a much more complicated network, it is not going to be so easy to figure out how to build equipment, let alone then to figure out what kinds of specifications to require in order to meet a technical registration. You now start going all the way back to the drawing board and learning each different kind of telephone, each different kind of function, and what you have to do to protect the network and to insure that there is no possibility of technical harm from attaching the device.

Ms. **Tiffany**. You strongly advocated divestiture as an alternative. However, do you think there is any legislative alternative to divestiture which, while perhaps not as effective as divestiture, might improve the approach taken in S. 898, for example, from a regulatory standpoint?

Dr. **Cornell**. Yes, I really do. I tend to think that divestiture is the best answer. I wish to make that clear. It is the cleanest, but divestiture at the local exchange level. That is, to take the monopoly franchise components and take them away from the competitive components.

Ms. **Tiffany**. How many components would you recommend for divestiture?

Dr. **Cornell**. Basically two. Split it at the local exchange level and let A.T. & T. decide. I mean whichever party is now A.T. & T. That is, if it is the local exchange—I am not talking the operating companies, but I am talking the local exchange portions—put all the long distance on one side and the local exchange on the other.

Ms. **Tiffany**. And retain equipment manufacturing and Bell Labs in the second component?

Dr. **Cornell**. The long-distance component.

Ms. **Tiffany**. That would be unregulated?

Dr. **Cornell**. I think yes, if you got rid of the bottleneck, if you got rid of the fact that one competitor owns the bottleneck, the piece that everybody must have access to. Yes, it is bigger. However, it also carries a lot of inherited baggage of old equipment, some of it I think outdated. They have a lot of catching up to do, too.

The other approach nobody has really talked about as much and nobody has sat down to do as much analysis of it as divestiture is to abolish monopoly franchising at the State level to allow in competitors offering local service. You might have to do that within a kind of period. I do not think it ought to be forever of saying cellular and the new digital termination services cannot be offered by A.T. & T. for a period of time to allow alternative ways of offering local distribution service to arise.

However, notice that right now local exchange service is a franchise monopoly. Only one group can do it in effect by law in most States, or by franchise agreement. That is where they get that very acute power of the monopoly. I mean the real monopoly power that will last for a long period of time, as opposed to the MTS/WATS monopoly that is beginning very slowly to erode but is nonetheless under competitive attack, is local distribution, the local exchange. That is theirs and theirs alone.

Ms. TIFFANY. Do you think actual competition would enter the local distribution and it would not be technically too difficult having to lay duplicate lines, or that it would require such substantial capital investment to make it prohibitive?

Dr. CORNELL. Not everybody is going to actually physically lay lines. What you are going to see is a much bigger mix of radio and wire mixtures of systems. I am not saying it is going to happen overnight, that if you abolish it tonight, tomorrow you go out and discover there are seven competitors in Washington, D.C., offering phone service.

However, there are entrepreneurs out there who have looked at it, who think it is feasible, who have filed in front of the Commission. A company named Millicom filed to try to do that using cellular in Raleigh, Durham. Unfortunately, it got badly treated by the Commission in terms of getting permission to go ahead.

The fact is that people are looking at it and thinking about it. Things like digital termination service, the XTEN proposal, as it was first called by Xerox, and cellular are technologies that potentially could come in and offer that kind of competition.

Ms. TIFFANY. Is what you are talking about complete deregulation of all telephone services?

Dr. CORNELL. At a minimum, complete deregulation of monopoly franchising. That is elimination of the regulatory barriers to entry.

Ms. TIFFANY. In addition, if we had our ideal legislative proposal, would it still make sense to keep regulation in the long lines or in the equipment manufacturing? Would that not all be deregulated as well?

Dr. CORNELL. My problem is I have been over there for 3 years and watched that kind of regulation flounder hopelessly. Again, it is not a lack of competence. It is an inability of the regulatory agency to ever acquire and master that kind of information in a timely fashion.

Far more effective is to bring competition in on all parts of the system. I do not want to say completely deregulate in one sense. The most successful kinds of regulation that I think the FCC engaged in were the kinds of things like GTE Telenet where the

Commission looked instead at structural kinds of remedies and how the market ought to be structured.

The development I think of such competition in the domestic satellite field was in part because there were structural bars on A.T. & T. from getting into that market early. I think some of the same kinds of requirements may be needed in the sense of saying not that we are going to keep you out forever or artificially, but you are not going to get in there ahead of time. You are not going to get in there before the market has had a chance to become competitive. You are not going to have a chance to sort of keep on squeezing everything else before it can even start.

Ms. Tiffany. Essentially rather than deregulating the local exchanges, perhaps just opening it to competition for awhile and allowing the FCC to regulate until competition is more viable?

Dr. Cornell. And instructing the FCC to look at competitive technologies as competitors to A.T. & T. rather than automatically the wire line carrier gets one and the RCC's get one. I mean to try to push the FCC away from that kind of division of the pie and to look at new technologies as potential competitors and to think about them from an antitrust kind of perspective.

Ms. Tiffany. Thank you.

Mr. Jasper, I have a few questions to ask you as well.

Is there any indication at the present time of how many fully separated affiliates A.T. & T. might establish under S. 898 and in what markets would these affiliates compete?

Mr. Jasper. My understanding of S. 898 is that it requires A.T. & T. to establish two new affiliates, one through which it would perform cable television and electronic publication type services in areas where it is not the franchised local telephone company. I have no idea what its intentions would be in that regard. Certainly they have not been announced.

The major affiliate with which we are concerned would be a conglomerate which would encompass all of the deregulated terminal equipment offerings and all of the nonbasic interexchange service offerings. We estimate those would be, at the time of deregulation, in the order of about $10 billion for terminal equipment and $5 billion for nonbasic interexchange services, based on present prices.

That same affiliate would be the one through which Bell would offer all other new enterprises that it would be able to engage in on an unregulated basis by virtue of the bill's efforts to set aside the 1956 consent decree. Principal attention has been given, for example, to Bell's possible entry into data processing services and perhaps into computer main-frame manufacture, although I think they have indicated that is not their intention. However, any other enterprises in which they might engage would be under that major conglomerate subsidiary.

Ms. Tiffany. How large do you think that subsidiary would be?

Mr. Jasper. Ignoring the transition period in the bill, with respect to certain deregulation, and setting the value of the potentially deregulated services at present prices, I estimate it would be in the order of $15 billion of existing telecommunication products and services. Of course, the amount for new enterprises that Bell would enter for the first time would be beyond my power, or perhaps theirs, to predict at this time.

Ms. TIFFANY. What kind of dominance do you think that would give them, or what kind of relative market power would that give them in the various telecommunications markets that one would expect them to compete in?

Mr. JASPER. In a word, overwhelming. My understanding is that with respect to the equipment business, which my companies are not involved in, Bell's dominance in particular product lines probably varies in the order of 70 percent at the minimum to something in the 90-percent range. In interexchange services, its dominance is in the upper 90-percent range.

Ms. TIFFANY. You stated in your testimony that the FCC could do virtually everything the legislation does, referring to S. 898, except lifting the antitrust consent decree. Would it not be necessary to lift the decree in order to allow A.T. & T. to engage in competition in certain business areas which it is now prohibited from engaging in and which would be permitted under 898?

Mr. JASPER. The FCC has experimented with the limits of its regulatory forbearance authorities. Those have been questioned by some, but they have been attempting to distinguish between dominant and nondominant firms and between subjects which are appropriate to deregulate and those which are not. Perhaps Dr. Cornell could speak further about that because I think some of those proceedings were underway when she was there.

However, the point is, as I think I said in my prepared statement, that while there are only two principal provisions of the bill which go beyond the FCC's current authority, we feel that to eliminate any doubt about the issue which you raise, a simple procompetitive policy and regulatory forbearance provision would be helpful additions. If there is any doubt, a one sentence or one paragraph authorization to that effect could be enacted.

Ms. TIFFANY. In your statement, you refer to the interests of the proponents of legislation in having Congress rather than the courts establish telecommunications policy. Why do you disagree with that objective?

Mr. JASPER. We think it is entirely appropriate for the Congress to establish telecommunications policy. The issue is that the Commerce Committees are attempting to establish antitrust policy. They are attempting to set aside a consent decree which is one means by which antitrust policy is effectuated. They are attempting to undermine an ongoing antitrust suit, whether deliberately or otherwise. And that qualifies my previous statement also. They would probably make it very difficult for private parties to successfully prosecute A.T. & T. for damages under antitrust violations if the bill were enacted because it would provide A.T. & T. a whole raft of new defenses.

Ms. TIFFANY. You did mention your concerns about the constitutionality of modifying the consent decree. To your knowledge, has any study been given this by any constitutional expert?

Mr. JASPER. To the best of my knowledge, the Office of Legal Counsel of the Justice Department has never been asked to render an opinion on the subject. During the last 2 or 3 years, there were three, or possibly four, papers prepared by the American Law Division of the Congressional Research Service.

However, those papers are all distinguished by the fact that they each questioned whether Congress had the power to set aside a consent decree. Nobody, myself included, challenges that. None of the papers that CRS prepared zeroed in on the precise question which is: Can the Congress, on the one hand, set aside a consent decree and, on the other hand, and in the same statute assert that it is preserving the antitrust laws inviolate?

This matter is gone into in a paper prepared by Joel Stillman, which I believe was attached as an appendix to Mr. McGowan's testimony which was furnished to you today.

Ms. **Tiffany**. Getting back to the congressional modification, you do refer in your statement to Bell's "insidious power." Are you suggesting that A.T. & T. has done anything improper in advancing this legislative proposal?

Mr. **Jasper**. No; unless one considers that lying and deceiving are improper. But, I suppose those are within the bounds of normal legislative representations. I think what Bell has done is use its extraordinary muscle, which is represented, among other things, by the fact that it has 3.5 million shareholders, 1 million employees, 1 million retirees, that it has a cozy relationship with such varied institutions as State utility commissions, independent telephone companies, the Department of Defense, that it has three powerful unions which are potent lobbying agents on its behalf, that it has been able to control the information that the Congress gets and dispenses only so much of it as it wishes.

In hearings in the Senate Commerce Committee in 1977, Senator Danforth asked then Chairman deButts, after he alleged that there were huge cross-subsidies flowing within the industry, if he could tell the committee for the record which services operated at a profit and which at a loss? Mr. deButts said, "No, we do not have that information."

Yet, 4 years later, they continue to allege that there are huge cross-subsidies that are threatened by competition, and they have proposed legislation which the Commerce Committee has adopted which is designed to deal with the effects of that cross-susidization about which they have never produced the relevant data. Other than that, they have done nothing improper.

Ms. **Tiffany**. Getting back to S. 898, do you have any specific proposals to make to strengthen the separation provisions between A.T. & T. and its fully separated affiliates?

Mr. **Jasper**. Oh, yes. There are a half a dozen perfectly obvious things that one could do by way of improving the separation between the parent and the affiliate—if one were unwilling to divest the relevant operations from the Bell System.

For example, there are provisions authorizing joint ventures and partnerships. Those are obviously totally inconsistent with the concept of separation.

There is joint institutional advertising and there is permission to use the Bell logo. In contrast, when SBS was established, the Federal Communications Commission ordered that it could not make use of the IBM, COMSAT, and Aetna names in its advertisements. Why should Bell be treated any differently from SBS?

Surely Bell poses a greater anticompetitive threat to everybody in the industry than SBS could possibly pose. Yet the bill treats Bell more liberally than the FCC treated SBS.

Similarly, when Telenet was acquired by GTE, the Commission imposed certain separation requirements, among which one was to prohibit GTE itself from going into any businesses duplicative of those in which Telenet was engaged. Joint ventures are also prohibited.

There are also two or three escape clauses in the bill by which Bell could practice unreasonable favoritism in connection with its affiliate. For example, there is an exemption on "independent prudent business judgment." There is a specific authority for the management personnel of the parent corporation to direct the affairs of the subsidiary, thus emphasizing what both Mr. O'Kelley and Mr. McGowan said earlier, to use the colloquialism: "There ain't no such thing as a separate subsidiary."

Ms. **Tiffany**. Mr. Jasper, we have gone through deregulation with a number of different industries, trucking, for example, and the airlines. There have been a lot of complaints about deregulation. Similarly, we are going through deregulation here and some of the opponents of deregulation perhaps can be accused of fearing competition.

Would you please comment on that?

Mr. **Jasper**. Yes. There are two things which absolutely distinguish the view of the competitors in communications from the view of those in airlines and trucking who opposed deregulation. The obvious one, of course, which is of rather massive significance is that Bell has, as we have discussed, anywhere from 80 to 98 percent dominance in the markets which we are talking about. There are probably no five firms in trucking or airlines or railroads that approached that level of dominance, let alone one firm. Therefore, we are talking about, if you will, a horse and a rabbit for comparison.

The second thing is equally significant. In airlines and trucking and railroads, you had foreclosure of entry under the regulatory regime. In contrast, in the communications area, the FCC has already opened the industry to free entry. Most regulatory economists will tell you that if you have a choice between regulating entry and regulating price, and you want to encourage competition, the thing to do is drop the barriers to entry. Those barriers have already been dropped. Competition is emerging in the field.

That is the problem: That A.T. & T. seeks, under the buzzword of "deregulation," to achieve the power to thwart the emerging competition by deregulation of its dominant enterprises. There is no logical rationale whatsoever for that. When Senator Packwood says, as he has in the press and has in the Commerce Committee markup, that there is competition and the competitors are making money, he is grossly exaggerating the facts. The facts are that almost every competitor in the long distance business is still operating "in the red."

I think perhaps MCI is the first one to become profitable. That happened only 2 or 3 years ago. And if you track that business from the time it was established, it has yet to wipe out its earlier losses.

With the 1 to 2 percent market penetration of long-distance competitors, it is totally absurd to talk about deregulating the dominant entity.

Ms. **Tiffany**. Mr. Jasper, in your statement, you refer to Bell's failure to adopt new technology. Nevertheless, I think everyone would agree that we in the United States have the best telephone service in the world. This certainly would indicate development of new technology. Can you please justify your statement?

Mr. **Jasper**. Yes. We certainly do not contest that we have an excellent telephone system in this country. Perhaps we have a telephone system which is without a superior any place in the world, but it is not true that with respect to every aspect of telecommunications the United States is in the lead.

Indeed, with respect to certain equipment innovations, other countries have clearly demonstrated superior talent and achievement: Such as Sweden, Japan, and Germany. With respect to transmission services, there are certain elements in Canada, France, and Britain which are at least equal to or superior to ours.

However, aside from that, since the advent of competition, there has been a whole array of innovations that have been introduced by both equipment and interexchange service competitors, innovations like packet switching and like switched private line. The very introduction of digital transmission and microwave transmission comes from the advent of competitive supply, not from initiatives of the Bell System.

Ms. **Tiffany**. Thank you, Mr. Jasper.

Dr. Cornell, would you briefly comment on whether in your opinion the FCC's attempt that Mr. Jasper mentioned to deregulate in certain areas—I assume you were referring to the computer 2 decision, Mr. Jasper?

Mr. **Jasper**. More than that. It is the competitive carrier rulemaking.

Ms. **Tiffany**. Would you comment as to whether you think the FCC has acted within the scope of its existing authorization?

Dr. **Cornell**. That is a tough one for me because I am not a lawyer. That is a particularly legal kind of question. I can only answer it from a kind of policy perspective and going back and looking at the act as a layperson, not as a lawyer. I really want to make that clear.

The competitive carrier rulemaking certainly was, in my mind, fully justified by what seemed to me to be section 1 of the 1934 act to guarantee insofar as possible to the American people an efficient nationwide system and reasonable rates and the like, and that where there was no possibility of firms engaged in that activity, to unduly charge or to engage in behavior that was either detrimental to competitors or to users of the system. In other words, there was no sense in putting them through a lot of procedural hoops. Now, whether in fact the act mandated all the procedural hoops, not being a lawyer, I cannot argue.

In the case of the computer 2, the problem is a much tougher one because just as the act never contemplated television, the act never contemplated there would be such a thing as data processing or computing at all, let alone the fact that it would be impossible to tell large segments of that industry from large segments of the communications industry.

In the data processing industry and in the computing industry, you very clearly had, even with a very large firm and a lot of smaller firms, a very active, competitive, technologically dynamic industry whose participants had made very clear in a variety of ways, forums, open speeches and the like that if it were ever subject to the kind of regulation that the telephone system was subject to, they were going to get out of the business. There was an anathema to being regulated. Yet it is part now of the same industry, or at least parts of it are part of the same industry.

The Commission was faced with a very real dilemma of the rock and the hard place. The choice facing the Commission was either to extend regulation over the data processing industry, or to try to find a way to cut it out of part of what was clearly telecommunications. There is no middle ground. There is no way to have both.

I mean as you were wrestling with 898, you either say this is regulated or it is not regulated. That is not something on which one can be on the fence on. Again, while I cannot answer it as a lawyer, I can tell you from a policy perspective of why the Commission found itself really having to deal with those issues.

Ms. TIFFANY. Thank you, Dr. Cornell and Mr. Jasper. I think that will end this panel discussion.

[Material follows:]

STATEMENT OF NINA W. CORNELL
OWEN, CORNELL, GREENHALGH, & MYSLINSKI, ECONOMIST, INC.

Mr. Chairman and Members of the Committee. I appreciate this chance to testify today on the question of whether the new duties that S 898 would impose upon the FCC can be accomplished by that agency. My unhappy message for you is that the Commission cannot accomplish the goals set for it by this bill. This conclusion does not rest on any lack of respect for the talents and capabilities of the Commissioners or the staff, but simply on the fact that the tasks assigned to the Commission cannot be accomplished.

The Basic Purposes and Methods of S 898

S 898 attempts to structure a new world in which all parts of the telecommunications system that are capable of being competitive are in fact competitive, and all other parts are effectively regulated. The bill envisions customer premises equipment, information services, and at least some kinds of long distance services to be potentially competitive now. The bill then seeks to mix in those markets a vertically integrated company (AT&T) that has as part of its activities a number of franchised monopoly, rate of return regulated operating companies with a number of much smaller, unregulated companies that have no incentives to engage in cross subsidization. The problem with such a mixture is that, in order to offer services at all, the non AT&T entrants in each of those markets must have access to the local franchised AT&T monopolies. Moreover, if that access is not on equal terms with their AT&T competitor's access, they may not be able to survive no matter how attractive their offerings. The magnitude of the problem can be seen by the fact that the local franchised monopoly components of AT&T serve approximately 80% of the American people.

The bill recognizes that such a mixture is fraught with the potential for anticompetitive behavior by AT&T, and so it mandates the use of both "fully separated subsidiaries" and detailed regulation by the FCC of some of the remaining regulated portions of AT&T. Unfortunately, neither the separate subsidiary approach nor the regulatory powers of the FCC (whether taken separately or combined) is able to control anticompetitive use of the franchised monopoly portions of the system. Separate subsidiaries, unless so completely separate as to constitute _de facto_ divestiture, do not change in the slightest the incentives of the firm to engage in predatory conduct if it can do so with impunity. And, it can do so with impunity because the kinds of regulatory activities to prevent such activity specified in the bill are those that, when examined closely, are the kinds of activities no Commission can perform.

A second and important aim of the bill is to reduce the amount of regulation of the telecommunications industry. While it _may_ achieve this goal as applied to other carriers some time in the future, doing so will depend upon how the FCC defines regulated and dominant regulated carriers, and upon what it classifies as basic telecommunications services. Neither outcome is assured. For AT&T and any other carrier classified as dominant, however, the bill unambiguously increases the amount of regulation that the FCC will be required to engage in. The paradox is that if AT&T's activities were restricted to purely regulated areas, the degree of regulation could be less than this bill calls for. The net effect, moreover, would be to require a significant expansion of the FCC if Congress wanted to have the agency even try to do the tasks required of it.

Before elaborating on these two points it is worth noting an anomaly in the bill itself. The belief that AT&T has incentives and the capacity unless checked to engage in anticompetitive behavior has been spoken to by the opposition to earlier versions of the bill by represenatives of the cable television, newspaper, and data processing industries, in addition to the competitors of AT&T in more traditional telephone activities. It is worthy of note that in several cases -- cable television and electronic advertising -- the anticompetitive potential is seen as so great as to require banning AT&T from those areas altogether. In other words, the legislation carries in it an inherent acknowledgement that no subsidiary or regulatory oversight can be effective in those markets despite the fact that they involve activities obviously distinct from simple telephone service. In short, if subsidiaries and regulations will not prevent anticompetitive behavior in markets that, because of their differences from the older telephone service, ought to be more easy to oversee, how can they then be viewed as sufficient in telephone markets?

Why the FCC Cannot Effectively Prevent Anticompetitive Behavior by AT&T Under S 898

S 898 mandates the FCC to prevent anticompetitive behavior using five basic regulatory tools: 1) reviewing the underlying cost information justifying tariffs; 2) establishing minimum technical standards governing interconnection of equipment to telecommunications systems; 3) regulating the terms and conditions of interconnection of competing long distance carriers to the local distribution providers; 4) reviewing and approving the need for investments to provide additional capacity for interexchange communications by AT&T; and 5) reviewing the terms and conditions under which the separated subsidiaries deal with the parent to be sure that the prices equal market prices (minus whatever AT&T can prove is due to lower costs or greater efficiencies). In short, the Commission is being set to work to oversee AT&T's cost accounting and cost allocation, its technical operating protocols, and its decisions about technological choices.

Unfortunately, S 898 seems to ignore the now almost fifty year history of the FCC. The three areas laid out -- understanding AT&T's costs, the competitive implications of its operating protocols, and its possible sets of technological choices -- are the three areas in which history has shown a complete inability of any Commission to regulate effectively. The long series of private line tariffs that have been found to be illegal by the FCC during the 1970's have been rejected in the main not because the FCC examined AT&T's costs, understood them and found expenses misallocated (although some of that did occur). The tariffs were found illegal because AT&T could never be made to provide sufficient information of that kind in the first place. The problem was succinctly described by then-Commissioner Kenneth Cox, in his separate statement on Telpak

> "I discern a very disturbing pattern in connection with all the bulk rate tariffs which have been filed in recent years. AT&T offers new services which are very attractive to large users of communications. Protest are filed by competitors who claim that the tariffs are discriminatory and will result in damage to their business. The Commission suspends the tariffs, but they go into effect at the end of the statutory 90-day period. Customers are attracted and come to rely on these services. If and when, months later, we find the tariffs to be unlawful, we are besieged by users complaining that it would be unfair to withdraw the benefits they have come to value. Some of these users are very substantial concerns whose operations no one would wish to disrupt. And where does this leave the Federal Communications Commission and the public it is charged to protect? In a very difficult position to say the least" (Underlining supplied).

Commissioner Cox noted the problem in 1964; the Supreme Court action that finally allowed termination of Telpak after the FCC found it unlawful, came in 1980. Sixteen years is a long time for competitors to wait for an end to each specific anticompetitive price.

The history of attempts by equipment providers to attach their wares to the Bell System network, once the FCC ruled that legal, shows how difficult it is for the Commission to deal with extremely simple and only slowly changing operating protocols. AT&T's first response was to require Bell-provided interconnect devices. When the FCC overturned that, after almost ten years, AT&T then tried to set more stringent technical specifications for competitors than for Western Electric. All this could only happen because the FCC could not master more quickly the technical details and operating protocols that would have allowed it to prescribe minimum technical standards in a more timely fashion.

Many observers believe that the technical registration program of Part 68 of the Commission's rules has solved this problem after twenty-five years. Perhaps it has. With the advent of digital technology and more rapid deployment of innovations (ironically, induced by competition), however, the protocols may become more complicated and may change more rapidly. If that happens, the equipment interconnection problem, viewed as "solved" today, may not remain "solved.

It should be noted, moreover, that nobody believes the problem of anticompetitive use of protocols to prevent competition in services has been solved. The present interconnection disputes between the specialized long-distance carriers and AT&T partially involve the protocols that determine how many digits customers of each have to dial. Still to come will be attempts to compete in providing the more simple enhanced services involved in custom calling and call forwarding. Here, too, protocols involving such things as how many of the digits of both the called and calling parties will be passed through the system (as well as how they are passed through) may determine whether there will be competition in the market. To date all the

Commission has been able to do in this area is to suggest that the parties negotiate.

As for regulating the choices of technology to be employed within the network, the Commission has only rarely tried, and then it has not always revealed itself to be very wise. The FCC initially frowned on the idea of rapid replacement of electromechanical switches by digital ones despite the large cost advantages of digital switches and their ability to offer features not otherwise possible. In fact, whenever possible, the FCC has tried to resolve these issues by negotiations among the parties rather than by prescriptions, an approach S 898 would encourage. Yet such negotiations, if the ENFIA negotiations are any guide, may permit AT&T to force some degree of price fixing on the competitors as the price of access to the local monopolies.

That these three areas should be areas of fairly dramatic if not spectacular failure by the FCC is not due to any lack of talent at the agency but to the inherent nature of those tasks themselves. To achieve each would require the Commission to acquire vast amounts of information, interprete it, and compare it with alternative possibilities. To understand each alternative, moreover, would also require the acquisition of vast quantities of information (and some of the alternatives may not exist anywhere except in theory). Once all this was completed, preferably rapidly, the Commission would be able to reach a judgment, only to find it had to begin the process over again immediately because the underlying technology had changed making the old work obsolete.

To give an idea of the magnitude of the task, the existing Uniform System of Accounts -- the one that is not detailed enough and needs replacing -- has seventeen different categories under the Telephone Plant heading. Under those seventeen categories are over 300 separate items. These items cover groupings as sweeping as "subscriber sets" and "switches", as well as ones as narrow as "operators' chairs". All groupings also will contain different vintages of equipment, with the more recent ones often having undergone a series of smaller or larger improvements over the earliest one. For example, there may be a large number of electromechanical crossbar switches (along with digital and step-by-step ones) in the switch grouping, but they differ by more than just how much they have been depreciated. Yet, for all three tasks -- ensuring proper cost accounting and allocation, understanding the implications of AT&T's operating protocols, and monitoring technological choices -- the FCC would need to acquire all that information and have it continually updated.

The kind of scrutiny that would now be required has two additional components from the ones the FCC has been unable to perform before. First, the FCC is mandated to keep AT&T's charges to its separating (but not yet separate) affiliates at market levels. As much of the equipment to which this injunction would apply has been marketed only within the Bell system and nowhere else, there may well be no independent market with which to compare prices.

Moreover, the oversight would drag the FCC into an additional trap it has only once gotten into before: trying to determine whether AT&T had experienced increased efficiency. In a recent rate of return proceeding the FCC allowed AT&T to earn an additional 0.5% if it could show that the gain came from more efficient improvements. After the return was earned, however, the FCC was unable to verify the cause. The FCC will be in no better position to make such determinations in the future.

If the sheer magnitude of data required did not render the task impossible, the problems of actually acquiring the data would. The only place from which to acquire all the necessary information is AT&T itself. Yet, if the company willingly and rapidly provides it, it is potentially giving up its ability to change prices and technical parameters in response to actions by competitors. Thus, it has very powerful incentives to delay, resist, and othewise impede the data collection efforts of the FCC. Once the company does accept the neccessity of revealing the information to the agency, because AT&T alone controls it, the firm is able to impart the information in a fashion that makes it very difficult to use. Again, the firm has an incentive to do this in order to delay the time when the FCC can effectively know what is required in order to stop potentially anticompetitive acts by AT&T. As long as the FCC cannot prove such behavior, AT&T can continue it and reap the gains from it.

Thus, any Commission finds itself facing tasks that, to really do well, require enormous amounts of information that has to be acquired from the very source that has the greatest incentive to prevent the agency from getting that information, and then require the agency to master it in a hurry. To add insult to injury, if the Commission ever should, by some miracle, manage to carry out those tasks, all it can realistically do is to tell AT&T to stop its old ways. There is very little the agency can do for any competitor who has gone bankrupt in the meantime. Moreover, as the history of the Telpak tariff reveals, powerful groups (DoD, large corporations, and the like) benefit from AT&T's anticompetitive behavior and use the full extent of the legal system to try to retain those benefits. Is it any wonder that the FCC has often thrown up its hands and ordered the lambs to go negotiate with the lion?

The Nonderegulatory Nature of S 898

The fact that the tasks assigned to the FCC are ones that cannot be carried out successfully is aggravated in S 898 by the fact that the bill would require the FCC to engage in them much more often than they have in the past. First, the FCC would acquire oversight over all intrastate toll. While this is not a net addition to the nation's regulation because the states now perform this function, the bill does add a new component. States would have to conduct some kind of regulatory proceeding to establish local exchange areas. These determinations are to be made according to guidelines established by the FCC, and they are to be checked by that agency.

Second, the bill would subject many more of AT&T's activities to cost and technical oversight than ever have been before. Today the FCC looks at tariffs for interstate services including the tariffs for interconnection of competitors to local exchanges. The Commission rarely if at all looks at such issues as the prices charged by Western Electric, Bell Labs, or the non-interconnect tariffs of the local operating companies. These, plus all exchanges between the Bell regulated companies and its fully separated subsidiaries, would now be the focus of mandatory detailed FCC cost/price oversight.

On the technical oversight side, the bill now adds all investments in increased facilities to what is today the §214 oversight of lines. The increased coverage seems more logical until the information requirements are understood. Because those requirements are so overwhelming, the Commission will not, in fact, be able to exercise any more effective control over AT&T's investments than before, but will do more regulating attempting to fulfill the reuirements of this bill. Moreover, the FCC now must begin formal oversight of operating protocols within the Bell network. This too is a new responsibility.

Not only do all of these duties mean expanded, not reduced regulations, they also will require sizeable additions in the budget, personnel, and computer resources, not mention office space, of the FCC if the agency is even to attempt to accomplish them. Without being scientific about my estimate I would not be surprised if the FCC would need another three hundred or more people in its Common Carrier Bureau. Moreover, some of the new regulators would need different skills from those of the current staff. The expanded technical regulation, for example, would require a large increase in engineers, particularly engineers with digital and computer skills that are currently very hard to attract to the government.

Similar resources will be needed by the special Joint Board to determine Exchange Access Charges established by §222, and by the FCC if it should use the surcharge authority granted in §202(e). The access charge will involve massive questions of costs. If the charge for the use of local facilities is set on a nationwide basis, of necessity the board will have to ignore the vast number of cost differences that arise from widely varying configurations of local distribution systems across the land. Differing sizes, ages, and local needs have led to different choices of technology, each with different costs of access. Additionally, different long distance carriers want different kinds of access, meaning a whole new array of cost calculations.

Once some determination of how to set access charges is made on a national level, some local exchange companies may need to receive subsidies from a surcharge to pay the costs they are not allowed to charge directly. Verifying the accuracy of asserted losses would be an enormous task. In the alternative, of course, the special Joint Board could order each local exchange to establish cost-based tariffs. Again, the cost accounting oversight is mind-boggling, and so will be the size of the staff of the joint board. Moreover, as technology changes that same staff will have to be added to the FCC if it has to redo the charges in the future to take those new technologies into account.

Conclusions

The basic goals that S 898 seeks -- to eliminate the anticompetitive potential of AT&T in order to allow competition and deregulation largely to govern telecommunications -- are the right ones to seek. It is the methods of S 898 that fail. The hard reality is that no regulatory scheme alone can ensure that AT&T competes fairly as long as it has both competitive and franchised monopoly components.

Ms. TIFFANY. Our next panel is constituted of Mr. Gus Grant, vice chairman of Southern Pacific Communications Co., and Mr. Stuart G. Meister, vice president and general counsel of American Satellite Company.

However, before the panel commences its discussion, I have been informed that Senator Thurmond is on his way to resume the chair. In fact, Senator Thurmond has just come in.

Senator THURMOND [chairman]. I ask these people to come up to the witness table: Mr. C. Gus Grant, vice chairman of Southern Pacific Communications Co., Washington, D.C., and Mr. Stuart G. Meister, vice president and general counsel of American Satellite Co., Rockville, Md.

You gentlemen may proceed now with your statement.

STATEMENT OF C. GUS GRANT, VICE CHAIRMAN, SOUTHERN PACIFIC COMMUNICATIONS CO., WASHINGTON, D.C.

Mr. GRANT. Senator, I appreciate being given this opportunity to testify today. My discussion of the communications industry will include S. 898 because that legislation has serious antitrust implications not only for Southern Pacific Communications but for the future of a competitive telecommunications industry as well.

Since the bill is moving forward in the Senate, I believe these hearings are most appropriate. I certainly commend you and the committee for holding them.

As I explained in my earlier testimony of June 17, Southern Pacific Communications Co., is a long distance transmission company. That is our business. We have our own long distance transmission network which is composed mainly of terrestial microwave. We have over 100,000 customers and we cover 138 cities in this country, which is about 80 to 85 percent of the population.

However, we must interconnect with the local telephone facilities in order to complete our calls. We got into this business about 7 years ago. Since the beginning, we have experienced the power of the Bell System in many different ways.

We have a private antitrust suit against Bell, and we will attempt to prove in this suit in a number of ways how A.T. & T. has engaged in an illegal program to maintain its monopoly in long distance communications. This of course does bear on the bill from the standpoint of the examples.

Let me give you an example. Initially and for some period of time, A.T. & T. refused to provide my company with interconnections necessary to provide certain services. A.T. & T. order and repair operations gave Long Lines preference over SP communications. This is still the case.

A.T. & T. placed arbitrary limits on the local metropolitan area in which we could obtain interconnection with them. A.T. & T. continually filed rates which it could not cost justify. This is still the case.

These are only some of the specific experiences we have had with Bell. As I said before, these are continuing in many cases.

We are in business because there is a need and a demand for our services by the American public. Customers needs were not being adequately met by the established carriers at the time we entered the business.

On the other hand, the courts have continuously upheld our right to be in this long distance business. Specialized carriers require equal opportunity for access to the facilities of the local telephone companies, whether it is Bell or the independents. Specialized carriers are not asking for special treatment, only equal treatment with Bell's Long Lines department.

Under the current industry structures of a vertically and a horizontally integrated Bell System, specialized carriers are in a unique and very uncomfortable position of being both a customer of the 23 local Bell operating companies, and at the same time we are competitors of the long-distance entity of the Bell System which is called Long Lines.

The incentive for discriminatory treatment exists and the A.T. & T. discriminates against the specialized carriers even today. All specialized carriers must use the Bell operating company facilities for local distribution. We cannot build our own local network.

The goal of S. 898, as introduced, was to achieve equality of treatment among all carriers, including the specialized carriers. However, the Commerce Committee changed the wording to equitable treatment. Equal has a definite meaning that a neutral forum can strive to achieve. On the other hand, equitable is subject to infinite interpretation.

Specialized carriers are very concerned that S. 898 will permit Bell to continue the endless litigation and arguments on the subject of why the specialized carriers should not have equal access and interconnection to the local bottleneck telephone company services and facilities.

Incidentally, on the term bottleneck, we call the local telephone companies bottlenecks because calls from all long distance carriers must go through their systems in any given city.

SP Communications believes that the cleanest way to promote competition in the long-distance-transmission area is to restructure the industry by making the local bottleneck telephone companies separate from long-distance companies. In this way, both the ability and the incentive of the local telephone company to discriminate in treatment of long-distance suppliers would be eliminated. We would all be treated alike.

Even though technology has advanced in the past years and new competitors have come into existence, the industry has not changed in one critical way and that is Bell's total dominance of all the factors of the communications industry.

We support legislation that takes into account A.T. & T.'s past conduct toward new competitors. The separate affiliate or separate subsidiary approach in S. 898 is not the answer because it still leaves Bell in control of both the regulated and the competitive sectors of the market.

Yet, the Commerce Committee has already essentially accepted the validity of our argument that the subsidiary approach to restructuring is not adequate to protect against cross-subsidization. For example, they specifically restricted A.T. & T. from competing in the newspaper business, even though that industry is a strong, well-developed, and healthy industry today. How can the new fledging competition such as the long distance competition be expected to stand up to the power of A.T. & T. if the Commerce Committee is not confident that the safeguards built into this bill will protect one of the strongest industries in this country?

The failure of S. 898 to demand a rigorous scheme of structural separation is one of its crippling flaws. Regular accounting will not do the job.

The problems of cross-subsidization that we have struggled against for the past decade arise from the total failure of regulation to police accounting manipulations by A.T. & T., the Bell Lab, or Western Electric, and the 23 operating companies, of which all but 2 are subsidiaries of A.T. & T.

Given that track record that has been developed on these so-called separated companies of today, we do not want to rely on the same accounting practices in the future. They have not worked prior to this time. We see no reason for a change.

We believe that S. 898 will not only frustrate and deter the development of competition, it will have an adverse effect on the Justice Department's antitrust suit against A.T. & T. and on the future enforcement of the antitrust law. The structural division in the legislation differs drastically from the division that the Justice Department is seeking in this suit. If Congress were to accept such a restructuring scheme as the legislation proposes, we believe this could affect Judge Green's ability to order the relief that the Justice Department is seeking.

We believe S. 898 is a special-interest legislation for the largest and the most powerful corporation in the world. We would agree with Sentor Holling's remark at the Commerce Committee markup on this that the bill is an A.T. & T. bill. It does not go to the heart of the underlying problem of the industry today. It merely creates the appearance of progress. It is mislabeled. It is not a competition and deregulation act as much as it is a regulatory and remonopolization act. Under this bill, a mammoth regulatory operation will need to exist in order to protect the consumers and the competitors. The size of such an organization makes this approach somewhat impractical.

Contrary to promoting competition, we believe the specific provisions included but not limited to the interconnection exchange access and separate affiliate provisions will actually frustrate and deter the development of competition and drive out much of the newly emerging competition.

For a business looking at entering this industry, S. 898 creates too much uncertainty as to whether competition will exist or can survive in this industry in the future. This bill requires major amendment. A few patches will not eliminte its antitrust impacts. This bill is so fundamentally flawed that it will require a significantly different structural approach in order to achieve its stated goals.

We look forward to working with the committee in developing these amendments that are necessary to eliminate the antitrust impacts of this legislation. Thank you very much.

Senator THURMOND. I have a few questions that I might propound to you.

What are the specific charges you have made against A.T. & T. in your pending lawsuit, and what is the status of that case? Do you expect S. 898 to have any impact on your case? Without going into detail, I thought you might just summarize that.

Mr. **GRANT**. Our suit against A.T. & T., which was lodged in March 1978, is for damages due to discriminatory practices which we are alleging have happened over a period of some 5 years. These practices relate to charges, the grade of service we have been given, the technical inadequacies of the service given us versus given to the Bell subsidiaries, mainly Long Lines, and generally a discrimination in the local access that we were given. In some cases we were refused this service for a period of time. That is a kind of a nutshell approach.

I believe your second question was——

Senator **THURMOND**. Will 898 have any impact on your case?

Mr. **GRANT**. Of course 898, if passed, would be well beyond the time limits of the suit, and not being a lawyer, I cannot really comment on that, but I believe it would generally create an attitude or a tenor that would not be as positive as it is today.

I believe your last question was what is the status of the suit. Our suit is in the discovery stage at this time. Also, depositions are being taken. We go to trial in Judge Richey's court here in Washington, D.C., on May 10, 1982.

Senator **THURMOND**. Where is the headquarters of Southern Pacific Communications?

Mr. **GRANT**. The headquarters of Southern Pacific Communications are in Burlingame, Calif.

Senator **THURMOND**. Will S. 898 in any way interfere with your ability to bring additional lawsuits should A.T. & T. in fact engage in cross-subsidization of its fully separated affiliate to your disadvantage?

Mr. **GRANT**. Again, this is one of the rare instances when I wish I were a lawyer, but I believe it would create a tenor that would discourage suits of that type.

Senator **THURMOND**. Is there any amendment that you could propose to S. 898 which would alleviate at least to some extent your concerns regarding cross-subsidization and interconnection problems?

Mr. **GRANT**. Yes, sir, there are four amendments that we believe could be put in that would strengthen this bill and make it a desirable bill and a more well-weighted bill.

The first relates to the structure of the Bell System. This is the fundamental issue, as far as we can see, to the success of this piece of legislation. We do not believe that the affiliate approach will work. I can only speak from business experience. I have served as president of three sizeable corporations in my career. I have had subsidiaries in every single one of these corporations, wholly owned subsidiaries. My experience has been that the subsidiary is controlled by the parent company because the parent company owns the stock and has the investment in the subsidiary.

If you look at the dictionary, you get the same definition, that an affiliate or subsidiary is controlled by the parent. We do not believe that this is workable in this piece of legislation. Therefore, the first step would be the divestiture of the operating companies from the balance of the Bell System insofar as long-distance competition is concerned. Make them separate ownership, under separate stockholders, and then their operations would be to serve all comers on an equal basis. That is point one.

As the bill is laid out, they define service as basic and enhanced. This is contrary to the normal operating, every day definitions of service in the telephone industry. Under the basic and enhanced definition, it almost is impossible to define where a service belongs.

We would recommend that rather than this type of definition the time-honored definitions born out from experience over many years of local exchange service and long-distance service be used. Both of these are well understood and they have survived the ravages of time.

The third point, as I mentioned in my talk, is that there was one word changed after the original Commerce Committee draft came out. This was a word that said that the competitors would receive equal service. This word was changed to equitable. It is difficult for me to imagine how one word could change the meaning of a paragraph so much as that one word did. We believe the word equal is appropriate if we are going to have competition that can truly get out and compete.

Senator **THURMOND**. On that point, without holding you to a dictionary definition, but in practical terms, how would you define equitable and equal?

Mr. **GRANT**. Let us take a practical example. If the Bell System offers A.T. & T. Long Lines a certain service, certain technical definitions of that service, and they offer us something that is different, then it is not equal. You have a black and white case. In engineering terms, it is possible to define equal service.

As to equitable, I am not sure. It depends on which side of the fence you are on. To me, when somebody comes along and says this is equitable service, but it is not as good as what we are giving A.T. & T. Long Lines, equitable in their definition is quite different than it is in mine.

If I cannot give my customer as good a service because of this particular connection as A.T. & T. can, then I do not have equitable connections or equitable service from Bell. However, I believe you could stretch this one out ad infinitum on what is equitable because you have two people arguing the case.

However, because this is a technical subject, equal can be defined, and defined very precisely. That is why we objected to the change in the word.

Senator **THURMOND**. Equal more or less means the same, does it not?

Mr. **GRANT**. Yes, sir, it does.

Senator **THURMOND**. Equitable probably means fair, would it not?

Mr. **GRANT**. Well, yes, it means fair, but fair from whose standpoint? A.T. & T.'s or in the case of my company, mine?

I have been told that we are getting fair treatment from A.T. & T. right now. Perhaps you can convert fair over to equitable, but from my standpoint and for my customers and the service I am able to offer, it is not equal. If it is equitable, it is their opinion, not mine. This is where we see a real fallacy in this particular word in the legislation.

Senator **THURMOND**. In other words, equitable treatment would not be as good treatment as equal treatment. Is that your point?

Mr. **Grant**. Generally speaking, that has been our experience, yes, sir.

Senator **Thurmond**. Thank you.

I believe our next witness is Mr. Stuart G. Meister, vice president and general counsel of American Satellite Co., Rockville, Md.

Mr. Meister, you may proceed.

STATEMENT OF STUART G. MEISTER, VICE PRESIDENT AND GENERAL COUNSEL, AMERICAN SATELLITE CO., ROCKVILLE, MD.

Mr. **Meister**. Thank you, Senator Thurmond.

Senator, good afternoon. As you have indicated, I am vice president and general counsel of American Satellite Co., with headquarters in Rockville, Md.

I appreciate this opportunity to appear before you to discuss the dangers of cross-subsidization in the telecommunications industry. By way of introduction, let me indicate that American Satellite and its predecessor, American Satellite Corp., have been providing telecommunication services since 1974. We now serve over 200 business customers with private line and concentrator facilities.

In addition, American Satellite provides service to a wide variety of private and governmental customers via networks of dedicated Earth stations and satellite channels of communication. To date, American Satellite has installed 60 Earth stations. An additional 30 Earth stations are either under contract or in various stages of construction.

American Satellite now operates as a partnership formed by Continental Telephone Co., the Nation's third largest non-A.T. & T. telephone company, and Fairchild Industries, Inc., a diversified aerospace company. Thus, American Satellite brings a unique perspective among the companies presently competing in the telecommunications industry.

Throughout the period since American Satellite established its first private line circuit, we have recognized that our principal competitor is A.T. & T. American Satellite, of course, competes with other satellite carriers, the microwave carriers, and other telecommunications entities, but A.T. & T. has always been perceived as the dominant force in the industry.

Let me illustrate the scope of A.T. & T.'s market power with one example comparing the revenues reported in the industry in 1980. According to the most recent A.T. & T. annual report, Bell System revenues for 1980 were in excess of $50 billion, $26 billion of which were derived from intercity services. Total revenues from A.T. & T.'s specialized competitors during the same period were approximately $750 million. American Satellite reported revenues of approximately $20 million in 1980.

ACCOUNTABILITY IN A DEREGULATORY ENVIRONMENT

The focus of this panel discussion is on cross-subsidization. I believe that the most important issue raised by the concept of cross-subsidization is one of accountability. More specifically, the question concerns the mechanisms which are required to insure that A.T. & T. does not abuse its dominant position in the marketplace.

If, as a matter of policy, you accept the premise that full and fair competition is desirable in the telecommunications industry, you are compelled to question any pricing theory which allows a dominant carrier to set rates that do not reflect the actual cost of providing service.

By definition, cross-subsidization is an artificial pricing mechanism which depends on the use of excessive profits derived from noncompetitive services to support competitive services which are priced at or below cost. Although it has often been argued, without hard evidence I might add, that subsidies benefit certain classes of telephone subscribers, it is difficult to conceptualize a system in which competition can long coexist with unfettered cross-subsidization.

The traditional solution to the problem of cross-subsidization has been to apply the techniques of rate regulation. However, as the FCC has now recognized, effective rate regulation of A.T. & T. may well be beyond the reasonable control of any regulatory agency. The central question to be resolved must therefore be how to hold A.T. & T. accountable for the anticompetitive consequences of cross-subsidization.

The prevailing wisdom suggests that the problem should be resolved with the minimum of governmental intervention and regulation. It has been suggested that the historical single focus regulatory approach with respect to dominant companies such as A.T. & T. no longer serves the public interest.

While many experts share this view, I do not believe that a consensus has been reached with respect to the desirability of dismantling the existing regulatory structure. Rather, by selectively deregulating the competitive segments of the industry on the one hand, and maintaining or creating a series of checks on A.T. & T.'s use of monopoly power on the other hand, it may be possible to protect the public interest by holding A.T. & T. accountable for its actions.

On the competitive side of the coin, it has been suggested that opportunities for cross-subsidization will diminish as the FCC implements its open entry policy in all markets, including the switched voice market. The prospective elimination of regulatory burdens which have previously hindered the introduction of new services and innovative rates, if fully applied to all competitive entities including satellite carriers, will permit more vigorous competition in all segments of the telecommunications industry and will further reduce the number of services where supra competitive returns can be maintained.

The flip side of the coin raises a more complex series of issues concerning A.T. & T.'s use of its dominant power. If, in fact, effective rate regulation is beyond the reasonable control of the FCC, it is essential that steps be taken to insure that A.T. & T. will not abuse its dominant position in the marketplace.

It must be concluded that broad policy statements condemning the evils of cross-subsidization will not reduce A.T. & T.'s dominance in the marketplace, nor bring A.T. & T. to the bar of accountability.

ACCOUNTABILITY AND S. 898

While the general policy statements contained in S. 898 is helpful in setting the correct tone for telecommunications policy and decisionmakers, they will not eliminate the problem of cross-subsidization. Cross-subsidization is deeply engrained in the Bell System's policies, business plans, and in the attitudes of its employees.

Because of the pervasive nature of cross-subsidization and the Bell System's history of introducing one unlawful long-distance rate on the heels of another, it appears that the best, and perhaps the only means of establishing the principle of accountability and eliminating cross-subsidization is by divesting A.T. & T. of its long lines division.

To date, the Congress has evidenced little interest in divestiture as a remedy for the problems which arise as a result of A.T. & T.'s continued dominance in the marketplace. Rather, there has been an effort to address these problems through the vehicle of a fully separated affiliate, or FSA. There are, however, a number of fundamental problems with this approach.

First, the ability of the regulatory agency to determine whether cross-subsidization practices are being used by A.T. & T. to give the FSA an unfair market advantage is in large part dependent upon the development of a uniform system of accounts and an accurate allocation of costs between noncompetitive and competitive services.

The Bell System has already informed the FCC that it cannot implement the currently proposed revisions to the uniform system of accounts until 1988. With this background, it is unrealistic to believe that the creation of a legislatively mandated FSA will cause A.T. & T. to become more cooperative in the implementation of necessary accounting changes.

Second, the creation of a FSA will require considerable regulatory attention to insure that all of the separations required between the dominant regulated carrier and the FSA are maintained. The FCC and the competitors of the FSA will share a burden of continually monitoring the activities of the FSA to insure that it is operating in the prescribed manner.

I might point out that Dr. Cornell, formerly Chief of the Office of Plans and Policy at the FCC, has estimated previously this afternoon that for the FCC alone, the burden of handling the regulatory oversight of this FSA would require at least an additional 300 people. An untold numbers of man-hours would be required by the competitors simply to make sure that the FCC was satisfying its responsibilities in the area.

If Congress elects to resolve the problems of cross-subsidization through the creation of a fully separated affiliate, far more stringent separation and accounting provisions than those currently included in S. 898 must be incorporated into the legislation.

For example, the division of services between the FSA and the rest of the Bell System should be drawn at the exchange/interexchange boundary, with the FSA limited to interexchange services. Any other division such as placing all "enhanced" or "information" or "competitive" services in the FSA, will result in disputes over whether each new service A.T. & T. wishes to introduce properly belongs in the FSA or dominant regulated carrier.

Second, partnerships, joint ventures, or other business arrangements between the FSA and other members of the Bell System or the dominant regulated carrier should be put on public notice for a period of 30 days. This would provide an opportunity for other carriers to scrutinize the arrangement and insure that such arrangements do not constitute a means of subsidizing the FSA's rates.

Carriers should be permitted to file comments with the FCC if they believe the arrangement is anticompetitive. No such partnership, joint venture, or other contractual arrangement should be permitted to go into effect if at the end of the 30-day notice period adverse comments had been filed, unless and until the FCC determines on the record before it that the arrangement is not anticompetitive. This determination should be made on the basis of an evidentiary type hearing.

The current language in S. 898 permitting the FCC to merely make such agreements available to the public is insufficient protection against cross-subsidization in this area.

Third, the FSA must be prohibited from owning local transmission facilities or from obtaining access to such facilities under terms different than are available to the competitive segment of the industry. Part of the goal of establishing an FSA is to insure that fair interconnection for all carriers exists. If the FSA is permitted to own its own local transmission facilities, or to enjoy "sweetheart" deals with the local operating companies, a strong incentive for fair and reasonable access would be eliminated.

Fourth, legislation should provide clear guidelines for the valuation of assets to be transferred to the FSA. The valuation should be made by the FCC rather than by the special board which is proposed in S. 898, a board which could be dominated by members of the industry such as A.T. & T.

Fifth, the legislation should impose a reasonable ceiling on the amount of capital A.T. & T. may contribute to the FSA in any 1 year. Without such limit, the FSA will be able to provide services at a loss and make up the lost revenue through capital contributions from its parent.

Sixth, the Bell System should be permitted to own no more than 70 percent of the FSA. This would provide extra levels of review by the SEC or by non-A.T. & T. owners.

Seventh, movement of employees between the FSA and the Bell System should be more severely restricted than presently required by S. 898.

The Bell System will undoubtedly argue that the imposition of restrictions such as those I have set forth will result in inefficiencies and loss of economies of scale which will somehow cost the consumer in terms of both price and service availability. There may well be a loss of some economies, but the Nation will gain more from a dynamic, competitive industry than it will lose by giving up some alleged efficiencies of vertical integration.

ACCOUNTABILITY—FURTHER STEPS

Even if Congress adopts all of the restrictions on activities between the FSA and other members of the Bell System which I have proposed, as well as those currently proposed in S. 898 and those proposed by other industry members whom you have heard today and during other hearings, I am not confident that an adequate system of accountability will have been established.

The FSA will remain as a member of the Bell System and there may still be the opportunity and incentive to cross-subsidize some, if not all, of the services it provides.

Therefore, the legislation should include a new provision permitting the FCC to alter the relationship between the dominated regulated carrier and the FSA as required to fulfill the goals of legislation. This continuing oversight should include the authority to require the Bell System to sell all or a portion of its ownership interest in the FSA.

CONCLUSION

New technologies such as wideband satellite data transmission, advanced terminal and switching equipment, as well as a regulatory environment more favorable to competition have brought about considerable change in the telecommunications industry in the past 10 years.

During this time, the telecommunications industry has also received a significant amount of legislative attention as Congress strives to fashion communications legislation for the 1980's and beyond. The restructuring of an industry in which one company, A.T. & T., is the dominant force is a complex undertaking and one which this committee, with its particular area of expertise, should carefully examine before any legislation is passed.

Thank you for this opportunity to testify on behalf of American Satellite.

Senator THURMOND. I have a couple of questions here that I would like to propound to you.

I believe you recommend that partnerships, joint ventures, or other business arrangements between the affiliate and other members of the Bell System be put on public notice for 30 days and further be subject to FCC approval. Is that correct?

Mr. MEISTER. That is correct.

Senator THURMOND. Do you think it would be unreasonable to prohibit all such joint arrangements completely?

Mr. MEISTER. Senator, I believe that the traditional doctrine requires arms-length arrangements between a parent and a fully separated affiliate. In the case of A.T. & T., there might very well be a justification for an absolute prohibition against such arrangements because of the difficulty in determining what constitutes an arms-length relationship.

Then again, in the interests of competition in the industry, it seems that one way to treat these arrangements is on a case-by-case basis. There may be some minor arrangements between the fully separated affiliate and the dominant carrier which could pass muster without complaint. On the other hand, such arrangements have the inherent capacity to blur the line between the fully separated affiliate and A.T. & T.

Senator THURMOND. I believe you suggested the Bell System should own no more than 70 percent of the affiliate stock. Is that correct?

Mr. MEISTER. That is correct.

Senator THURMOND. Is there some reason for this particular figure, or would a smaller amount of outside ownership be just as adequate?

Mr. MEISTER. Senator, there is always a question in corporate control as to what constitutes a sizeable enough block to prevent the majority owners from controlling the way the company does business. Thirty percent outside or non-Bell ownership constitutes a significant enough amount of outside ownership to insure that the management of the fully separate affiliated are called to task for any questionable relationships between that company and one of the Bell operating companies. While a lesser amount, may be sufficient, from a long-range standpoint a larger amount, on the order of 30 percent, is preferable.

Senator THURMOND. In your opinion, what specific benefits would result from such outside ownership, other than what you have already mentioned?

Mr. MEISTER. The point I was attempting to make in my testimony today was one of accountability. It seems to me that the goal of any legislation in this area should be to establish ground rules which will limit regulatory oversight and intervention, but nevertheless establish a set of boundary lines on the way the dominant regulated entity operates.

I believe that one of the ways to accomplish accountability is to have outside or non-Bell ownership, which can act as an ombudsman to offset the control exercised by A.T. & T.

Senator THURMOND. I believe that that completes the testimony today from all of these panels. We wish to express our appreciation to all of you who testified today.

We will now recess until 10 a.m. tomorrow, at which time we will resume the hearings.

[Whereupon, at 4:10 p.m., the committee recessed, to reconvene on Friday, July 24, 1981, at 10 a.m.]

[Prepared statements follow:]

Testimony of

C. GUS GRANT
Vice Chairman, Southern Pacific Communications Company

I. INTRODUCTION

Thank you for giving Southern Pacific Communications Company (SPCC) an opportunity to return and discuss in detail the specific problems that we experience because of the structure of the telecommunications industry today. We will frame our discussion to include the antitrust aspects of S. 898, the Telecommunications Competition and Deregulation Act of 1981 as it was ordered reported from the Senate Commerce, Science and Transportation Committee on July 16, 1981. Because the telecommunications industry is so totally dominated by one company, AT&T, communications issues and policy overlap antitrust issues and policy. These must be considered in conjunction with each other. A discussion of monopolization and competition in the industry must include discussion of S. 898 since it has major antitrust implications and is moving forward in the Senate.

In this testimony we explain the antitrust implications of this bill for the specialized carriers. SPCC has a private antitrust suit against AT&T. The discriminatory treatment of specialized carriers by AT&T is a major part of the Government's antitrust suit against AT&T and we explain why S. 898 would seriously diminish the likelihood of the court awarding effective structural relief.

II. WHAT IS A SPECIALIZED COMMON CARRIER?

Specialized common carriers (SCCs) can be described briefly as companies that have their own long distance transmission facilities but which must interconnect with the local telephone facilities of the telephone companies in order to complete their calls. Today specialized common carriers account for only about one percent of the long distance market. The Federal Communications Commission (FCC), in a series of decisions, authorized SCCs to exist. The FCC stated in its Specialized Common Carrier Services decision that:

> "There is no doubt as to the validity of the staff's conclusion that there is an increasing and widespread public demand for the availability of diverse and flexible means for meeting specialized communications requirements, and a substantial public need for the proposed service offerings--a need which has not been adequately met by the established carriers." 1/

1/ 29 FCC 2d 870 at 907-908.

The courts have consistently upheld the specialized carriers right to compete with the Bell System in the long distance market.

What Do Specialized Common Carriers Want?

Specialized carriers want equal opportunity for access to the bottleneck facilities of the local telephone companies. SCCs want the opportunity for the same kind of access that the Bell System's long distance entity has. SCCs are not asking for special treatment nor are we asking that Bell be kept out of our markets.

Specialized common carriers are both customers of the 23 Bell Operating Companies which serve over 80 percent of the phones in this country and, at the same time, competitors of the long distance entity of the Bell System which is commonly referred to as Long Lines. As we explained in our introductory testimony, on June 17, specialized carriers are in the unique position of being both a customer and a competitor of AT&T. The incentive for discriminatory treatment thus exists and indeed AT&T discriminates against specialized carriers even today.

What Did S. 898 Say Regarding Interconnection and Access to Bottleneck Facilities?

Interconnection and access to the facilities and services of local bottleneck telephone companies is vital to the existence of specialized carriers. There are two sections in S. 898 that deal with SCC rights to interconnect with local bottleneck telephone company facilities. They are Section 207, Interconnection, and Section 222, Access Charges. In the original version of S. 898 as introduced, Section 222 stated that

> "It is the purpose of this section to establish a system of exchange access fees for the use of the services and facilities of exchange carriers by telecommunications carriers and other customers, in order to--
>
> (1) achieve equality of treatment among all telecommunications carriers and other customers using the services of each exchange carrier...." (emphasis supplied)

The Senate Commerce Committee staff prepared a 10 page summary of the bill when it was introduced which contained 22 items. There was no description of the interconnection provisions of the bill but there was a discussion of the access charge section. This is what part of that description said:

> "12. Access Charges--The FCC is directed to establish a system of charges for use of local telephone facilities that will (1) ensure that all long distance carriers and other customers are treated equally;...." (emphasis supplied)

Through negotiations between the Commerce Committee staff and the telephone industry--but not specialized common carriers, it was agreed to amend the access charge section of the bill to read:

> "It is the purpose of this section to establish a system of charges for exchange access, in order to--(1) achieve equitable treatment among all telecommunications carriers and other customers using the services of each exchange carrier...." (emphasis supplied)

Specialized carriers are very concerned that this change in the words "equality of treatment" to "equitable treatment" constitutes a retreat that will permit Bell to continue the endless litigation and arguments on the subjects that have prevailed in the so-called ENFIA negotiations. "Equal" has a definite meaning that a neutral forum can strive to achieve. Equitable is subject to infinite interpretation. Judging by the treatment we have been accorded, there is a slight chance that we will ever get "equal" facilities or interconnection under this standard.

Contrary to the title of this bill, the Commerce Committee has not assured the specialized carriers of equal standing in the long distance market. We believe this change is a step backward away from a competitive telecommunications industry in direct frustration of the intent of the FCC, the Courts and the earlier stated intent of the bill drafters of S. 898.

What Is The Answer to the Specialized Carriers' Problem

SPCC believes that the cleanest way to promote competition in the long distance transmission business is to restructure the industry by making the local bottleneck telephone facilities and service separate from long distance. In this way both the ability and incentive of a local telephone company to discriminate in its treatment of long distance suppliers will be eliminated. This is the remedy that the Justice Department is seeking based on its investigation of AT&T's past conduct.

This is the best way to ensure that specialized carriers will get equal treatment. SPCC believes that with the horizontally and vertically integrated Bell System, the incentives and ability exist for the local Bell Operating Companies to continue to give favorable treatment to its long distance carrier. We make these statements based on experience.

AT&T argues that since the government's antitrust suit was brought against it in 1974, circumstances have changed which now make the government antitrust suit inappropriate and make the structural remedies being sought also inappropriate. While we agree that a very different industry exists today than existed in 1974, that technology has advanced and new competitors have come into existence, the fundamental element that has not changed is AT&T's ability and incentive to use its overwhelming market power to frustrate the development of competition. Even today, specialized carriers are victims of Bell's continuing campaign to give discriminatory access to its long lines facilities insofar as local exchange facilities are concerned. Remedies short of divestiture invite a gamble for the SCCs and do not remove the incentives or ability of AT&T's member companies to act in the best interest of the whole. As an illustration of the frustration visited upon the specialized carriers in the last few years of negotiations for equal facilities, we are attaching some of the most recent correspondence.

III. COMMUNICATIONS POLICY OVERLAPS ANTITRUST MATTERS

The Bell System today is not a re-born benevolent giant under new leadership committed to the advancement of full and fair competition. Rather, the Bell System today continues to have and to use its monopoly power in violation of the antitrust laws, in violation of the Commission's regulatory dictates and in support of its continuing policy to keep one integrated system.

The Justice Department filed the present antitrust suit against AT&T in 1974. It seeks remedies designed to prevent anticompetitive practices from continuing. It stated that:

> "Because the Bell Operating Companies are owned by AT&T, the parent company has the ability to exercise direct control over their conduct and, as the evidence will show, has in fact done so in a way that severely disadvantages AT&T's competitors."

The Justice Department has stated that Bell's anticompetitive conduct continues into the present day environment.

SPCC's Antitrust Suit Against AT&T

SPCC, up until 1978, hoped that AT&T would change its anticompetitive behavior and start treating competitors fairly. We did not rush into an antitrust suit because we were aware of the enormous cost involved in such litigation. When hope for satisfactory treatment became futile, SPCC filed its own private antitrust complaint against AT&T in the U.S. District Court of the District of Columbia.

In our complaint, we charge AT&T with the willful maintenance of its monopoly in the intercity business telecommunications market in violation of Section 2 of the Sherman Act. In essence, SPCC is seeking damages for injury resulting from AT&T's unlawful response to the entry of competition of SPCC and others in the intercity business telecommunications market. The complaint also seeks injunctive relief to prevent AT&T from continuing its anticompetitive behavior. Failing in its efforts to block FCC approval of specialized common carrier competition, AT&T commenced a comprehensive pattern of anticompetitive behavior aimed at barring the new entrants.

As alleged in SPCC's complaint, AT&T acted on two principal fronts. First, by restricting access to essential interconnection facilities needed to carry SPCC's intercity signals to local customers, AT&T foreclosed the new competitors from a substantial part of the market. Second, AT&T used its monopoly power to manipulate rate structures.

AT&T realized that the anticompetitive structure and rate levels of its existing Telpak tariff would insulate the vast majority of intercity private line services from competitive inroads, but would not protect the relatively small portion of the market that remained vulnerable to competition, i.e., individual voice grade private line services. It, therefore, undertook to develop a new "competitive" rate structure, known as "Hi-Lo." Claiming that it developed the "Hi-Lo" rates after conducting cost studies to identify the "high capacity, low unit cost" elements of its network, AT&T filed the new tariff. Hi-Lo increased rates for "low density" services, while drastically reducing rates for "high density" services. Not coincidentally, the "high density" areas included 90% of the anticipated specialized common carrier cities. We believe that AT&T was aware that there was in fact no or relatively little discontinuity in costs between its so-called "high density" and "low density" rate centers, but nevertheless told the FCC that the different rate levels "reflected" cost differences.

When AT&T failed to convince the FCC that the differences in the Hi-Lo rates were cost justified, the Commission ruled the tariff unlawful and ordered AT&T to file a replacement. The replacement MPL tariff, together with its supporting materials, shared many of Hi-Lo's characteristics and was also held unlawful. Both Hi-Lo and MPL resulted from the artificial manipulation of AT&T's rates -- manipulation that was possible only because of AT&T's monopoly position -- in order to implement non-cost justified selective rate custs aimed at specialized common carrier competition.

Unfortunately, AT&T's inability to obtain FCC approval for Hi-Lo and MPL did not prevent the challenged rates from remaining in effect while their lawfulness was being investigated and in the case of MPL, remaining in effect after they were found unlawful by the FCC years ago up to and including the present time. Thus, the anticompetitive impact of these rates have been felt by the specialized carriers during most of the period from SPCC's commencement of service until the present.

AT&T's interconnection restrictions and rate structures meshed so as to maximize the impact on SCCs. To the extent that a rate structure may have left some small market segment susceptible to competition, the competitor was likely to be foreclosed by an interconnect restriction. And to the extent that AT&T was constrained to provide interconnections, it structured its tariffs so that most of the vulnerable segments would be protected by artificially low rates.

Document discovery by both sides has been ongoing for many months and is now largely completed. Depositions are scheduled to commence this month. Judge Richey, to whom the case has been assigned, has set a firm trial date of May 10, 1982.

Our case and MCI's case, which is now awaiting decision in the 7th Circuit on the appeal from a $1.8 billion verdict for MCI, are, of course, very similar. A number of contentions in our case are also at issue in the government's case which is now being tried before Judge Greene in the District Court here.

SPCC's Intervention in 1956 Consent Decree Case

AT&T petitioned the U.S. District Court in New Jersey for "construction" of the 1956 Consent Decree. In 1956, an antitrust suit brought in 1949 against AT&T and Western Electric was settled by execution of a Consent Decree between the Department of Justice and AT&T. Justice agreed to drop its suit to obtain divestiture of Western Electric from the Bell System, and AT&T agreed to limit its business activities to providing common carrier communications services the charges for which are subject to public regulation.

For 25 years, this agreement was understood to mean what it said. However, on March 4, 1981, AT&T petitioned the New Jersey Court for a "construction" of the Decree to allow it to do virtually everything that it agreed not to do for a quarter century.

"Construction" of the Decree as proposed by AT&T in its March, 1981 Motion, would allow AT&T to use its vast size and monopoly power to destroy competition in the same non-regulated areas from which it has been barred. "Construction" as proposed would also enable AT&T to gain competitive advantages over those communications companies with which it competes in providing traditionally regulated basic communications services. Therefore, on April 27, SPCC submitted to the Court a memorandum on the merits of AT&T's motion.

In SPCC's judgment, the 1956 Decree reflects the realization that competitive abuse by AT&T is very likely if it is allowed into non-regulated businesses unless proper structural safeguards are established.

Impact of Legislation on Antitrust Suits

AT&T witnesses in the past have stated they were not seeking legislation which would save them from potential punishment for any past antitrust violations. Rather, they were trying to convince Congress to set a new statutory structure for the Commission and courts to handle future conduct.

Unfortunately such AT&T recommendations belie reality. Passage of significant common carrier legislation such as S. 898 will have an impact on all of the pending antitrust litigation. In the Justice Department's current antitrust suit against AT&T, millions of pages of depositions and testimony have been taken. Scores of witnesses have been heard and seven years of preparation have gone into this case. It is a well founded case and the Justice Department intends to prove its contentions against AT&T. In the judgment of that expert agency charged with antitrust enforcement, the U.S. Justice Department, nothing during the past seven years has mitigated the need for divestiture and restructuring of the Bell System to prevent anticompetitive abuses. The number of pending private antitrust suits against AT&T illustrates the industry-wide effect of Bell's size and power and its use of that power.

S. 898 would statutorily abolish much of the 1956 Consent Decree notwithstanding the fact that the anticompetitive incentives which gave rise to the Decree 25 years ago continue to exist today. These actions, both public and private, have been necessary despite the continued validity and enforceability of the 1956 Decree. The Justice Department believes as we do, that continued interpretation of the Decree as it was intended in 1956 -- to keep AT&T out of unregulated markets -- is no less essential today than it was in 1956.

Passage of S. 898 would conflict with the efforts of the Department of Justice to enforce the antitrust laws. The Justice Department and the courts have an obligation to enforce the antitrust laws of this country and the economic policies underlying those laws, and any communications legislation should recognize those obligations. Passage of a bill which effectively abolishes the 1956 Consent Decree and prevents effective prosecution and obtainment of appropriate remedies if antitrust violations are proven, would be inconsistent with those obligations.

Therefore, it is SPCC's recommendation that no legislation which interferes with the ability of the Justice Department to enforce the 1956 Consent Decree, or to prosecute the 1974 antitrust suit be adopted. We would support legislation that properly takes into account AT&T's past conduct toward new competitors and calls for a meaningful restructuring along the natural lines of the industry as the Justice Department is seeking.

We agree with the Justice Department's position that:

> "although adoption of S. 898 should have no legal effect on the government's position in U.S. v. AT&T, it will, as a practical matter, seriously diminish the likelihood that the trial court will be willing, if the government prevails, to award effective structural relief." 2/

The Justice Department went on to say that

> "Although S. 898 contains an antitrust savings clause, Section 404, which states that passage of the bill is not to be construed to affect pending antitrust litigation involving AT&T on the availability of structural relief, we believe that S. 898's passage could

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2/ Letter from William F. Baxter, Assistant Attorney General, Antitrust Division, U.S. Justice Department, to the Honorable David Stockman, Director, Office of Management and Budget, May 27, 1981, p. 1.

> have an adverse impact on the Department's AT&T litigation." 3/

Here are some of the reasons. The restructuring proposed in S. 898 ignores the reality of the industry today. It also ignores the antitrust record that has been built to show that AT&T has and continues to treat its own corporate family in a preferential way, and that it discriminates against the new long distance carriers.

The structural division of activities between the parent and the fully separated affiliate are not logical. Instead of following the traditional structural markets of the industry which would be local telephone service, long distance service, and manufacture of telecommunications equipment, the bill adopts a structural approach along the lines of basic and enhanced telephone services.

In the lawsuit, the Justice Department seeks structural changes based upon the underlying structure of AT&T and the industry as a whole. The Justice Department recently said

> "Simply put, we seek to separate AT&T into two components, the operating companies, which would provide only regulated exchange area service, and a competitive entity, containing Western Electric, Bell Labs and an expanded Long Lines, that would offer equipment and enhanced and intercity services." 4/

S. 898 in contrast distinguishes between basic and enhanced telephone services. It will require no divestiture of any sort. Because this approach to restructuring differs so drastically from that proposed by the Department of Justice, we believe it will influence the court toward limiting its relief in a manner consistent with the legislation. Such an impact has been the publicly stated legislative objective of the Bell System.

The Vice President and General Counsel of AT&T told the House Judiciary Committee last year that

> "A legislative determination of the future structure of the Bell System... should end the matter until Congress acts again. We do not believe it sensible or fair to expose the Bell System to double jeopardy by permitting the Department of Justice suit for divestiture to proceed." 5/

Bell argues that there are economies of scale in its vertically integrated system

These claims have never been conclusively proven from

3/ *Ibid*, p. 5.

4/ *Ibid*, p. 4.

5/ Statement of Howard J. Trienens on behalf of AT&T at hearings on H.R. 6121, The Telecommunications Act of 1980 before the Subcommittee on Monopolies and Commercial Law of the House Committee on the Judiciary, Sept. 1980.

cost information. While there may be gains from network optimization versus fragmentation, there are costs such as the loss of a stimulus to innovation. The problem is that tradeoffs exist. The question is can the market that is so dominated by one company be relied upon to resolve such tradeoffs?

It is significant that Bell recently changed the title of Bell Labs' R&D funded under license contracts from "Basic Research and Fundamental Development" to "Basic Research and Systems Engineering." In the past, Bell has maintained that only a horizontally and vertically integrated system will result in a socially optimal telecommunications system. The basis of this assertion is the necessity of comprehensive system planning under unitary management to optimize network planning and construction. The assumption is that fragmented responsibility and conflicting competitive interests lead to suboptimization and inhibit network-wide planning and innovation. It is asserted that fragmented management may optimize individual plant but not optimize the system.

Does monopoly control by AT&T guarantee socially optimal results?

Neither the unregulated monopolist nor the regulated monopolist has an incentive to operate in the public interest. The regulated AT&T has an incentive to expand its investment base, maximize its market share and to control the pricing of its capital inputs through integration. The question is does the institutional structure of the Bell System promote realization of gains from socially desirable optimization. This cannot and has not been demonstrated.

How has Bell allocated its R&D funds?

Bell's allocation of R&D funds has been focused on long distance transmissions and customer premise terminal equipment. It is in these areas that competition has been most likely. Bell has allocated relatively little research funds to local distribution where it has a 100% franchized monopoly. The implication is that Bell's massive infusions of R&D have been used to retain market share. According to Touche Ross in Docket 19129:

> "In view of the significance of local loops on operating costs, it would appear reasonable to expand research and development resources on a proportional basis.... It is apparent that the research and development effort on loops has not reflected the cost basis. (Final Report, Appendix to Class A--Issue 5, p. 136.)

Optimization assumes system planning to meet known demands.

Optimization does not take into account uncertainty and change. Optimization may not be realized where uncertainty and change occur. Bell did not respond to inadequacy of its network for data signals. Our economic precepts do not accord such immense power to a single private entity unless no alternative system is viable. It is now being demonstrated that other systems are viable. One could cite many facility choices which, in retrospect, were non-optimal. Uncertainty in rapidly changing dynamic industry make it unlikely that a single body can optimize the technical and economic tradeoffs in the design of a network.

Other justifications for integration.

Bell has justified integration between operating levels and manufacturing on the ground that they are technologically interdependent. The need for coordination does not necessarily require ownership and control. It may be necessary where the market will not provide services or products. Are these considerations significant in communications?

After Bell acquired Western in 1881 it refused to sell to independent telcos. This stimulated the growth of independent manufacturers, and Western reversed its policy. In recent years Western, as a captive supplier provided 85 percent of the equipment market and the independents about 15 percent. In recent years the large independent telcos have acquired most of the nonaffiliated manufacturers prompted largely by the 1956 Consent Decree's approval of the utility-supplier tie.

Gains from integration which may potentially exist under an unregulated competitive market structure are evaluated in the final market where sales are outside the firm. Under regulation these gains can never be evaluated by the market. The regulated monopolist has an incentive to manipulate transfer prices within the firm rather than to exploit economies from integration.

Is it feasible to combine regulated and unregulated units in the same firm?

Assuming rate base/rate of return regulation, the answer is no as a matter of principle. The unregulated profit maximizing firm should evaluate each investment project on a standalone basis. The value of the firms common equity will be maximized if it adopts all prospects whose expected internal rates of return exceed the risk-adjusted cost of capitol. The firm subject to rate base regulation such as AT&T, on the other hand will tend to invest in projects that are unprofitable at existing prices. If the result is to lower its overall rate of return it will be given wide lattitude to adjust rates to achieve the allowed return. An unregulated firm that prices below costs looses profits. A rate base regulated firm does not. In fact it increases profits if it expands investments. The incentive of the regulated and unregulated firms is obviously in conflict. The regulated firm is provided a limited guarantee against the risks of capital loss by transferring these costs from stockholder to its customers. As a result, utility stock is like a low risk variable rate bond rather than an unregulated firms common equity.

Combining regulated and unregulated activities in the same corporation has two results. First, there is an incentive to shift the costs (risks) of capital loss from its unregulated activities to its regulated activities where they can be passed on to customers. Second, the unregulated activities can be financed at low cost of capital rates that reflect the favorable terms available to the regulated firms' stockholders.

Creation of unregulated separated subsidiaries does not alter either problem. The creation of separate subsidiaries itself will become part of the corporation's strategic planning rather than be independent of the corporation's decisionmaking. For illustration, investments in technically separable activities can be made to look and be joint so that they cannot be placed in separate subsidiaries.

At the practical level the question is can a corporation possessed with overwhelming size, complexity and power be held accountable where regulatory jurisdiction is divided and fragmented and regulatory resources small, and where the corporation holds enormous discretionary power over the level and direction of its investments, expenses, and research and development activities. The answer is not reassuring.

Separate affiliate/subsidiary is a contradiction in terms

We want to call to your attention a dictionary's definitions of affiliate and subsidiary. An affiliate is "a member." A subsidiary is "a company wholly controlled by another."

As long as the fully separate subsidiary is unregulated, Bell can avoid effective regulation by adjusting accounting prices between the regulated and unregulated levels. Given the parent-subsidiary relationship, any intracorporate transfer of prices will be arbitrary and will not isolate the competitive subsidiary from its parent's monopoly base. AT&T's ability to set up unregulated subsidiaries gives AT&T the flexibility to transfer its regulated monopoly power to unregulated markets. Thus, paradoxically, the fully separate subsidiary approach reduces, rather than enhances the effective regulation of Bell's monopoly market, and enhances, rather than reduces, Bell's ability to engage in anticompetitive conduct.

Impact of cross-subsidization on competitive markets

AT&T's capacity and incentives to cross-subsidize are reflected in the sources of intracorporate transactions and revenue flows within the Bell System, and by patterns of rates in competitive and monopoly markets. Cash flows within Bell are created by sales of products and services, equity and debt financing, dividends, contract license agreement, and revenue divisions (among regulatory jurisdictions). Bell Labs' basic research is funded through license contract agreements with monopoly local operating companies, which relate funding to a percentage of gross revenues. There is no check on either the level or direction of these activities. Publicly available studies have shown that Western's costing and pricing practices shift costs from products serving competitive markets to products serving monopoly markets. Separations underlies the division of revenue process. The basic collection and organization of data and detailed processes are carried out by AT&T. It is highly improbable that they accomplish a separation of monopoly exchange costs and competitive interexchange costs in a manner that would identify and allow detection of subsidies.

Examples of areas now cross-subsidized

- With few exceptions, state commissions have not required separation of basic exchange costs from state toll, private line and "vertical services." Where special studies have been conducted they generally have found that basic exchange service was subsidizing other services. (See Docket 20003 First and Second Reports).

- To the extent that competition has forced the premature retirement of certain terminal equipment product items, it is common practice to charge the unauthorized costs off against higher depreciation charges to other terminal equipment products in the group depreciation account.

- AT&T has mounted costly crash programs in TD-2 microwave and data under voice technology to preempt potential competition or to drive out competitors.

- Many state commissions have concluded that the local operating companies have subsidized research and developmental activities for Bell Labs where they were of primary benefit to the process of developing competitive products.

The structural separation proposed in S. 898 does not alter the incentives to cross-subsidize. Moreover, intra-corporate transactions and flows now take place within the Bell System between separate affiliates which are demonstrably subsidies. The separate subsidiary structure does not cure these practices. S. 898 is an undefined, nebulous construction which does not limit many of the practices which now take place.

Legislative approval of a subsidiary structure is bad precedent.

Adoption in legislation of the affiliated structure is likely to initiate a period of trust formation and conglomeration to rival the 1890s and 1920s. After the 1956 Consent Decree accepted vertical integration in communications, the industry became vertically integrated to a degree unmatched in any other industry. Adoption of the current legislation has much wider implications. It would remove any antitrust roadblocks to both vertical and horizontal integration anywhere.

Effects of S. 898 on capital formation

The effect of the S. 898 structure on capital formation derive (1) from the favorable terms available to utilities whose stock is perceived as a riskless variable rate bond, and (2) from the market foreclosure effects that horizontal and vertical integration would allow. Acceptance of the integrated structure can enormously raise the capital costs of entry by others into telecommunications by precluding entry into limited segments of the industry.

In the transmission business, entry requires construction of new facilities. AT&T's dominance is so great that takeovers of other telephone companies would not provide entry to the intercity market or stimulate competition. Competitors who can change the structure of the industry must enter by constructing new systems from scratch and scaling major barriers to entry. New entrants must establish credibility with customers who are wondering whether the new competitors will survive; and the new firms must compete against customer loyalty to the Bell System. New entrants must obtain local connections for which they must give detailed customer and technical information to Bell. Under these structural conditions the risks of entry and the capital required are both high. Any acceptance of the existing holding company industry structure, and more important, any extension of it to new areas will increase entry barriers and capital requirements.

The people problem

S. 898 fails to recognize a human problem that in many respects accounts for the illegal activities leading to antitrust violations. A company that competes in the market and at the same time provides a very essential service to its competitors for which there is no alternative, inevitably creates a loyalty problem for its employees. Employees who are in a company segment which provides local service to a competitor, as well as AT&T Long Lines, cannot help but discriminate in favor of Long Lines simply because their basic loyalty (and pension) is logically attuned to company operations. Employees in the management categories are regularly transferred among Bell's operations today. Advancements in the management ranks create the loyalty pressures and almost assure discriminatory acts in favor of the AT&T units. These kinds of pressures should not be permitted to exist because they will inevitably defeat the intent of the legislation.

IV. CONCLUSION

Legislation such as S. 898 which contains a subsidiary approach to restructuring of the industry will undermine the antitrust laws.

S. 898 is special interest legislation for the largest and most powerful corporation in the world.

We believe it is extremely important that this bill, S. 898, be discussed and examined to reveal its true nature. As Senator Hollings of the Commerce Committee commented at the mark-up on this bill, it is an AT&T bill. S. 898 does not go to the heart of the underlying problems in the industry today, it merely creates the appearance of progress.

S. 898 has been mislabeled. It is not a competition and deregulation act as much as it is a regulatory and remonopolization act. Many of the provisions will require a mammouth regulatory responsibility in order to protect consumers and competitors. Further, we believe the specific provisions including the interconnection, exchange access and the separate affiliate provisions will actually frustrate and deter the development of competition and drive out much of the newly emerging competition. The Commerce Committee has already essentially accepted the validity of our argument that the subsidiary structure is not adequate to protect against cross-subsidization. The newspaper industry which is a strong and healthy industry convinced the Committee that they needed protections from AT&T stronger than the subsidiary safeguard, however, we are afforded no such protection yet we are not nearly as strong.

This bill requires major amendment. A few patches will not eliminate its antitrust impacts. This bill is so fundamentally flawed that it will require a significantly different structural approach in order to achieve its stated goals.

We look forward to working with the Committee in developing amendments necessary to eliminate the antitrust impacts of this legislation. Thank you.

June 10, 1981

Mr. Arthur David
Chief, Tariff Review Branch
Common Carrier Bureau
Federal Communications Commission
Washington, D.C. 20554

Emily Williams, Esq.
Legal Assistant to Chief of
  Domestic Facilities Division
Common Carrier Bureau
Federal Communications Commission
Washington, D.C. 20554

RE: ENFIA III Negotiations

Dear Mr. David/Ms. Williams:

This letter addresses AT&T's Responses to ENFIA III Inquiries (AT&T Responses) filed on June 1, 1981, as well as the accompanying AT&T comments and representations; it represents the joint reply of the undersigned competitive intercity carriers (OCCs) who are participating in the ENFIA III negotiations.

While the OCCs have been hopeful that the ENFIA III negotiations will make genuine progress toward obtaining the exchange access interconnections to which they are legally entitled, but which have been previously denied by AT&T, the position reflected in AT&T's Responses appears to indicate that its fundamental attitude towards nondiscriminatory interconnection with the OCCs remains unchanged. Specifically:

o AT&T continues to maintain, in its Responses as well as in its comments at the initial April 29 meeting in ENFIA III, that it will not provide to the OCCs the same exchange access (i.e., access to essential monopoly facilities it controls) which it provides to its own competitive intercity operations.

- Although not objecting at the initial April 29 ENFIA III meeting to the inclusion of costs within the scope of the negotiations, AT&T's response categorically refuses to discuss all relevant costs of, and cost-justified rates for, providing exchange access to the OCCs.[1]

AT&T also refuses to discuss the costs of, and compensation paid for, exchange access provided to its own intercity operations.[2], [3]

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[1] AT&T has refused to discuss, among other items (1) the costs of providing exchange access under ENFIA A, B or C, (2) whether such "costs" have ever been substantiated in any jurisdiction, (3) the cost methodology upon which such rates are or would be predicated, (4) whether facilities obtained under ENFIA A differ in any way from ordinary single line business telephone service, and (5) the costs of providing alternative interconnect arrangements to the OCCs.

[2] In this regard, we assume that AT&T's position here has been agreed to by its partners in the intercity enterprise.

[3] Among other non-responses, AT&T has refused to discuss the costs of, or compensation paid for, the myriad services and facilities which the Bell Operating Companies provide to AT&T's competitive intercity operations but do not provide to the OCCs, including (1) marketing of long distance service, (2) billing and collection for long distance service, (3) support for legal costs pertaining to intercity service, (4) support for research and development pertaining to intercity service, (5) free business and personal telephone service for employees of its intercity operations, and (6) the substantial array of exchange access technical arrangements which are not provided to the OCCs or proposed in ENFIA B or C. These matters are highly relevant to ENFIA III negotiations, in that the OCCs must not be charged for services and facilities which they do not receive, and further, the OCCs are entitled to technical parity.

At the April 29, 1981 organizational meeting for ENFIA III, the OCCs were in agreement that the scope of the negotiations must properly include the full "menu" of exchange access technical accommodations which AT&T makes available to its own intercity operations, and equally important, must determine the costs and rates to be applied to such exchange access arrangements. The OCCs stressed that the scope of the negotiations must also include facilities obtained under the existing ENFIA tariff, i.e., exchange access via business line facilities as operationally utilized in the industry under the existing ENFIA Interim Settlement Agreement (ENFIA A). AT&T did not object, at the April 29 meeting, to this definition of the scope of the ENFIA III proceedings.

AT&T now maintains in its Responses, in effect, that the scope of ENFIA III negotiations should exclude discussion of all relevant costs and, indeed, discussion of the very exchange access arrangements upon which today's competitive intercity market is predicated. Clearly, the FCC Public Notice initiating the ENFIA III negotiations (dated April 22, 1981) placed no such restriction on the scope of negotiations. Indeed, the Notice specifically stated that the initial April 29 ENFIA III meeting would be to "focus the issues" and to discuss plans for the negotiation of such issues. As indicated, all of the OCCs are in agreement that these proceedings must address costs and rates pertinent to the full range of exchange access arrangements, including those for facilities now being obtained under ENFIA A. Indeed, AT&T itself has made all such costs and rates an integral part of this proceeding, by incorporating rate elements 1 and 3 from ENFIA A into its ENFIA B and C proposals.

It is most important that the Commission understand the AT&T position for what it is. Bell has indicated, in its Responses, that it will not negotiate rates for ENFIA A, B or C in these proceedings. AT&T categorically states that its "response does not address the costs and rates for rate elements 1 and 3,"[4] which are the predominant elements of the rates for ENFIA A, B and C. Further, AT&T maintains that the costs and rates for element 2 of ENFIA B and C "can be best addressed in a review of information which would be filed pursuant to Section 61.38 of the Commission's Rules and Regulations."[5] In other words, AT&T proposes to present cost data only in connection with a unilateral tariff filing. The only logical inference which can be drawn from AT&T's response is that it is unwilling to negotiate rates for ENFIA facilities. Furthermore, its statement that the OCCs' desire to negotiate ENFIA rates will delay improved interconnection constitutes a threat by AT&T to hold hostage negotiations on interconnection quality, subject to its demand that the OCCs accede to unilaterally imposed ENFIA rates. It is impossible to conduct a meaningful commercial negotiation without consideration of price, and consideration of all relevant costs. At the very outset of these critical negotiations, AT&T has walked away from the negotiating table on the key issues of costs and rates.

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[4] AT&T Responses at 101.

[5] Cover letter to AT&T Responses at 2.

The OCCs wish to vigorously pursue any discussions which can potentially lead to equitable forms of interconnection to monopoly local exchange facilities. Moreover, the OCCs remain ready, willing and able to pay a fair price for such facilities. However, in view of AT&T's repeated efforts in the past to economically thwart the FCC's pro-competitive decisions, while ostensibly providing facilities, the OCCs are convinced that these negotiations must address the issues of costs and rates. Only by so doing can the OCCs and the Commission ensure that detailed technical discussion is not a hollow exercise in regulatory futility. It is in pursuit of improved interconnection that the OCCs take the position that this proceeding must be predicated upon agreement as to costs. Otherwise, the OCCs are asked to obtain and pay for facilities without knowing the costs of such facilities.

As is uniformly recognized, the ENFIA rates have never been justified on the basis of cost. Despite this lack of cost support data, and the fact that the ENFIA tariff clearly represents no more than an interim arrangement as to highly controversial rates, AT&T now seeks to apply these non-cost justified rates to interconnect arrangements which were never even discussed in the initial ENFIA negotiations.

In initiating these negotiations, the Commission has opted for negotiated access charges, as preferable to its undertaking to prescribe rates. The ENFIA Interim Settlement Agreement terminates on April 19, 1982, unless the Commission, prior to that date, decides that it is in the public interest to extend the agreement and determines an appropriate level of payment for the use of jointly used subscriber plant to be applied during the extension period. Under these circumstances, two scenarios are possible: Either the parties will have reached an agreement in the ENFIA III negotiations on an appropriate rate to replace the existing ENFIA rate, or it will be necessary for the Commission to determine a rate prior to April 19, 1982. Whether the ultimate replacement for the existing ENFIA rate is a negotiated or Commission determined rate, it is necessary to begin now to ascertain relevant costs in order to provide a valid predicate for a cost-justified rate.

A third scenario is contemplated by AT&T, *i.e.*, discussion of technical issues followed by an eleventh hour unilateral AT&T tariff filing just prior to the expiration of the existing ENFIA agreement. This would precipitate substantial litigation and undertainty concerning essential monopoly facilities, by potentially forcing the Commission to determine a rate in the absence of an adequate record. Conversely, by seeking to negotiate cost and rate issues concomitantly with the technical issues related to quality and forms of interconnection -- particularly since rate elements 1 and 3 are common to ENFIA A, B and C proposed by AT&T -- the OCCs hope to achieve an orderly, record-supported resolution of the kinds of interconnection to be available to them and the applicable rates for such interconnection.

With respect to technical arrangements, the OCCs agreed at the April 29 meeting, and AT&T implicitly concedes in its Responses, that AT&T's ENFIA A, B and C proposals do not represent parity with the exchange access which AT&T provides to its own intercity operations. Nonetheless AT&T refused, in its Responses, to discuss, in any significant way, exchange access arrangements other than ENFIA B and C. The rigidity of the AT&T position in this regard should not go unnoticed by the Commission; in effect, AT&T appears to view possible interconnection arrangements which would more closely approach parity as being off limits and totally non-negotiable. In particular, AT&T has declined to discuss the full range of interconnection arrangements which it provides to its own intercity operations, and to discuss the cost of providing such local access to the "Bell/Independent intercity enterprise." Instead, AT&T maintains that there are no "clearly drawn lines between local and intercity facilities" of AT&T, and between AT&T and the local facilities of the Independent telephone companies. Obviously, it is in AT&T's interest to obfuscate the exchange/interexchange boundary with respect to access charge issues.[6]

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[6] We note that AT&T quite inconsistently tries to justify its refusal to discuss any further options suggested at the ENFIA II meetings on the ground that following those discussions "a functional separation between local and intercity portions of the AT&T/Independent public switched network was defined" (Responses p. 88) but by a process and in a manner Bell fails to describe.

Finally, AT&T's representation that the parties requesting information have sought to instill a "litigative atmosphere," and to develop information for use in other proceedings, cannot be permitted to stand without rebuttal. AT&T's self-serving posturing cannot mask the documented fact that AT&T introduced its ENFIA B and C proposals in the Government antitrust suit against AT&T the very same day on which it was filed at the FCC.[7] Indeed, AT&T's simultaneous use of this document in the Government antitrust case, coupled with its unwillingness to discuss rates in the ENFIA III negotiations, strongly suggests the possibility that AT&T's ENFIA III proposals were designed primarily for use in the antitrust court.

In view of the foregoing, the OCCs respectfully request that AT&T be required to respond fully to all interrogatories submitted by the OCCs, including those relating to the costs of all elements of ENFIA A, B, and C, and to the costs of, and compensation paid for, the full "menu" of technical interconnection arrangements which AT&T provides to its own intercity operations. The OCCs view resolution of cost issues as a matter of urgent priority, and seek to go forward with negotiation on these issues as soon as AT&T's responses are completed and can be analyzed. Should AT&T continue its refusal to discuss costs and rates, it will have effectively terminated meaningful negotiations, even though success of the Commission's policies favoring competitive provision of interexchange communications services is directly dependent upon the Commission's ability to encourage successful ENFIA negotiations between AT&T and the OCCs.

7/ U.S. V. AT&T, Civ. Action No. 74-1698 (D.D.C.), AT&T cross-examination of Mr. Bert Roberts, Senior Vice President for Operations, MCI, April 27, 1981, Tr. 5672, 5693.

Respectfully submitted,

MCI TELECOMMUNICATIONS CORPORATION

Philip S. Nyborg

Philip S. Nyborg
Vice President for
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SOUTHERN PACIFIC COMMUNICATIONS COMPANY

George J. Vasilakos

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Leo I. George

Leo I. George
Its Attorney

SPC SPCommunications*

July 17, 1981

Gary Epstein, Esq.
Chief, Common Carrier Bureau
Federal Communications Commission
Washington, D.C. 20554

Re: ENFIA III Negotiations

Dear Mr. Epstein:

This letter is in response to the letter of AT&T dated June 26, 1981, concerning its view of the scope of the ENFIA III negotiations. SPCC believes that AT&T's letter omits several material facts, and misstates others.

Perhaps the most important fallacy in AT&T's position is at page 3 of its letter (note **), where it states:

> Access charges for OCC use of exchange facilities are, in general, the subject of the Commission's CC Docket No. 78-72 interim access charge plan, which is also pending decision. An attempt to negotiate the very issues now pending the Commission's decision after a full cycle of pleadings in both those dockets would be totally inappropriate.

This is at best a highly misleading statement. All parties should agree that the "access charge plan" proposed in Docket No. 78-72 deals only with the question of ratebase, or revenue requirement, for the ENFIA service category. */ It does not purport to address the questions of rate levels or rate structure for ENFIA, issues which are as critical to SPCC as the accurate determination of the ENFIA revenue requirement which these rates should be designed to recover. Thus, contrary to AT&T's allegation, adoption of an "access charge plan" in Docket No. 78-72 will leave several crucial issues concerning the appropriate rates for ENFIA unresolved. More accurately, such issues would be left to AT&T's sole discretion in its unilateral development of a tariff filing containing a rate structure of its own choosing. Hopefully no one at the Commission is naive enough to believe that this rate structure would be the one */ most conducive to efficient and viable competition by SPCC.

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*/ It is not the purpose of this letter to discuss the merits or lack thereof of any particular plan actually proposed in Docket No. 78-72.

The existing rate strucure of ENFIA **/ was agreed to by SPCC and other carriers solely as part of the Interim Settlement Agreement resulting from the ENFIA I negotiations. It was never investigated by the Commission, and was never accepted by SPCC as anything but what it is -- agreed upon dollar levels of ENFIA charges to be applicable for a limited period while its "rough justice" had its roughness eliminated in further forums. Thus, ENFIA rates, as they exist today, are not a valid basis upon which to add or subtract components, or from which appropriate permanent rates for existing or modified technical arrangements can or should be extrapolated.

Furthermore, the technical configuration of existing ENFIAs (i.e., local business lines) was simply assumed to be the case for purposes of the ENFIA I negotiations. Questions of technical improvements necessary to fulfill AT&T's legal obligation to provide non-discriminatory local distribution to competitors of its intercity enterprise were simply beyond the scope of those early negotiations.

Since ENFIA I, circumstances have dramatically changed. The nature and scope of SPCC's service offerings have evolved far beyond their initial limited status. Implications of both the technical form of interconnection and the rate structure under which it is provided have emerged as critical problems to SPCC's development.

It is for all of these reasons that SPCC has consistently maintained that comprehensive negotiations designed to lead to a comprehensive and permanent replacement for the limited Interim Settlement Agreement in ENFIA are both necessary and appropriate. Such negotiations must include discussion of and agreement upon what technical improvements are possible (and when) as well as the rate structure under which these revised ENFIA offerings will be provided. In view of the expiration of portions of the Interim Settlement Agreement in April of 1982, these negotiations should proceed as soon as AT&T can be made to provide the information essential thereto.

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*/ There are almost an infinite number of possible rate structures which can be designed to recover an identical revenue requirement. Compare, for instance, the now-effective WATS rate structure with its predecessor. The Commission should recall that in its latest WATS Order it admitted candidly its inability to resolve all the rate structure issues presented by AT&T's tariff filing before its effectiveness.

**/ Putting aside for a moment the question of whether the ENFIA ratebase should include SPF components acknowledged by all parties, including AT&T, to be totally non-cost-based.

In order to meaningfully discuss the rate structure and rate level questions which are central to the negotiations, it is essential that SPCC be provided relevant cost and engineering data by AT&T. For this reason SPCC, together with USTS and SBS, submitted data requests to AT&T on May 13, 1981, which sought information concerning the availability (insofar as AT&T was concerned) of a list of 33 components of improved interconnection, AT&T's proposed rates for such components, and AT&T's cost justification thereof. AT&T, with the limited exception of engineering questions related to its own ENFIA B and C concepts, essentially refused to respond. SPCC submits that AT&T's position, as is clear from a reading of its responses, is simply not as stated in its June 26, 1981 letter. ("AT&T has never indicated that these optional arrangements have been made on a take-it or leave-it basis.")

In addition to the necessity of the type of cost and engineering data SPCC has requested as as basis for negotiations concerning the rate structure of a comprehensive replacement for the interim ENFIA agreement now in effect, SPCC believes that this data (as well as information obtained during our review and discussion of it with AT&T) would prove very useful in assuring the accuracy of any "access charge plan" or methodology used to determine the ENFIA revenue requirement. SPCC is therefore of the view that action on any access charge plan in Docket No. 78-72 should occur after the comprehensive negotiations have resulted in a permanent replacement for the existing interim ENFIA agreement. In effect, to the extent that the parties agree, suggested stipulations concerning portions of the "access charge plan" could be proffered to the Commission as part of the settlement agreement, thus minimizing future litigation concerning it.

SPCC believes that the above approach represents the best way for the Commission to proceed. AT&T, by refusing to enter into such comprehensive negotiations, is clearly attempting to retain control over the future shape of ENFIA by maximizing the role of its unilateral tariff filing, knowing from past experience that the Commission will not be able to review it in detail and prescribe an alternative. Since the future of SPCC and the competitive intercity marketplace is at stake, we seek the opportunity to have as much meaningful input in this process as possible.

The problem thus comes down to whether the Commission will force AT&T to meaningfully negotiate these issues. We urge the Commission to do so.

It has been over six years since the Commission ordered AT&T's monopoly operating companies to deal with SPCC and other carriers "no less favorably in interconnecting its facilities than they do now for the Long Lines Department of AT&T." */ Enforcement of this requirement is long overdue, and if negotiations cannot implement it due to AT&T intransigence, Commission action will clearly be warranted. We hope the Commission will first take all available steps to attempt to make the negotiation process work toward a comprehensive replacement of the Interim Settlement Agreement which is in accord with this AT&T obligation.

Sincerely,

George J. Vasilakos MAT

George J. Vasilakos
Executiv Vice-President
Engineering & Operations

cc: All Parties listed in
letter of Arthur B. David
(Ref. 61610) dated July 9,
1981.

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*/ 44 FCC 2d 245, 247, (1973), 46 FCC 2d 413 (1974), affd 503 F. 2d 1250 (1974), cert. denied 422 U.S. 1026 (1975).

TESTIMONY OF

STUART G. MEISTER
VICE PRESIDENT & GENERAL COUNSEL
AMERICAN SATELLITE COMPANY

Mr. Chairman and members of the Committee, good afternoon. My name is Stuart G. Meister. I am Vice President and General Counsel of American Satellite Company. I appreciate this opportunity to appear before you to discuss the impact of cross-subsidization in the telecommunications industry.

I. INTRODUCTION

American Satellite Company and its predecessor, American Satellite Corporation, have been providing telecommunications services since 1974. The Company now serves over 200 business customers with private line and concentrator facilities. In addition, American Satellite provides service to a wide variety of private and governmental customers via networks of dedicated earth stations and satellite channels of communication. To date, American Satellite has installed 60 earth stations. An additional 30 earth stations are either under contract or in various stages of construction.

American Satellite now operates as a partnership formed by Continental Telephone Corporation, the nation's third largest non-AT&T telephone company, and Fairchild Industries, Inc. a diversified aerospace company. Thus, American Satellite has a unique perspective among the companies presently competing in the telecommunications marketplace.

Throughout the period since American Satellite established its first private line circuit, we have recognized that our principal competitor is AT&T (sometimes referred to as the Bell System). American Satellite, of course, competes with other satellite carriers such as Satellite Business Systems, RCA American Communications, Inc. and Western Union Telegraph, and with the specialized carriers such as MCI Telecommunications and Souther Pacific Communications Company, and other entities, but AT&T has always been perceived as the dominant competitive force in the industry.

Let me illustrate the scope of AT&T's market power with a comparison of revenues reported in 1980. According to the most recent AT&T Annual Report, Bell System revenues for 1980 were in excess of 50 billion dollars, 26 billion dollars of which were derived from intercity services. Total revenues from AT&T's specialized competitors during the same period were approximately 750 million dollars. American Satellite reported revenues of 20 million dollars in 1980.

II. ACCOUNTABILITY

The focus of this panel discussion is on the concept of cross-subsidization. I believe that the most important issue raised by the concept of cross-subsidization is one of "accountability". More specifically, the question concerns the mechanisms which are required to insure that AT&T does not abuse its dominant position in the marketplace.

If, as a matter of policy, you accept the premise that full and fair competition is desirable in the telecommunications industry, you are compelled to question any pricing theory which allows a dominant carrier to set rates that do not reflect the actual cost of providing service. By definition, cross-subsidization is an artificial pricing mechanism which depends on the use of excessive profits derived from non-competitive services to support competitive services which are priced at or below cost. Although it has often been argued, albeit without hard evidence, that subsidies benefit certain classes of telephone subscribers, I find it difficult to conceptualize a system in which the competition can long coexist with unfettered cross-subsidization.

The traditional solution to the problem of cross-subsidization has been to apply the techniques of rate regulation. However, as the FCC has now recognized, effective rate regulation of AT&T may well be beyond the reasonable control of any regulatory agency. 1/

1/ AT&T (Manual and Procedures for Cost Allocation), 78 F.C.C. 2d 1296, 1307 (1980).

The central question to be resolved must therefore be how to hold AT&T accountable for the anticompetitive consequences of cross-subsidization. The prevailing wisdom suggests that the problem should be resolved with a minimum of governmental intervention and regulation. It has been suggested that the historical, single focus regulatory approach with respect to dominant companies such as AT&T no longer serves the public interest. While many experts share this view, I do not believe a concensus has been reached with respect to the desirability of dismanteling the existing regulatory structure. Rather, by selectively deregulating various segments of the industry on the one hand, and maintaining or creating a series of checks on AT&T's use of monopoly power on the other hand, it may be possible to protect the public interest by holding AT&T accountable for its actions.

On the competitive side of the coin, it has been suggested that opportunities for cross-subsidization will diminish as the FCC implements its open entry policy in all markets (including switched voice). The prospective elimination of regulatory burdens which previously hindered the introduction of new services and innovative rates, if fully applied to all competitive entities (including the satellite carriers), will permit more vigorous competition in all segments of the telecommunications industry and will further reduce the number of services where supra competitive returns can be maintained.

The flip side of the coin raises a more complex series of issues. If, in fact, effective rate regulation is beyond the reasonable control of the FCC, it is essential that steps be taken to insure that AT&T will not abuse its dominant position in the competitive marketplace.

It must be concluded that broad policy statements condemning the evils of cross-subsidization will not reduce AT&T's dominance in the market or bring AT&T to the bar of accountability. Thus, while general language contained in S.898 is helpful in setting the correct tone for telecommunications policy and decision makers, it will not eliminate the problem of cross-subsidization. Cross-subsidization is deeply engrained in the Bell System's policies, business plans, and in its employees. Because of the pervasive nature of the cross-subsidization policy and the Bell System's history of introducing one unlawful long distance rate on the heels of another, 2/ it appears that the best, and perhaps the only means of establishing the principle of accountability and eliminating cross-subsidization is by divesting AT&T of its Long Lines division.

To date the Congress has evidenced little interest in divestiture as a remedy for the problems which arise as a result of AT&T's continued dominance in the marketplace. Rather, there has been an effort to address these problems through the vehicle of a fully separated affiliate ("FSA"). There are, however, a number of fundamental problems with this approach.

First, the ability of the regulatory agency to determine whether cross-subsidization practices are being used by AT&T to give the FSA an unfair market advantage is in large part dependent upon the development of a uniform system of accounts and an accurate allocation of costs between non-competitive and competitive services. The Bell System has already informed the FCC that it cannot implement the currentely proposed revisions to the uniform system of accounts until 1988. 3/ With this background it is unrealistic to believe that the creation of a legislatively mandated FSA will cause AT&T to become more cooperative in the implementation of necessary accounting changes.

2/ See, e.g. AT&T (Multi-Schedule Private Line Rates), 74 FCC 2d 1, 50 (Dissenting Statement of Commissioner Joseph R. Fogarty).

3/ Revision of Uniform System of Accounts, CC Docket No. 78-196, FCC 79-479, (Mimeo No. 14438). See also AT&T (Manual and Procedures for Cost Allocation), 78 F.C.C. 2d 1296, 1307 ¶34, 1308 ¶37 and n. 23 (1980), adopted, 84 F.C.C. 2d 384 (1980), stay denied, FCC 81-193 (adopted April 23, 1981), partial reconsideration granted, FCC 81-224 (adopted May 7, 1981), appeal pending sub nom. MCI Telecommunications Corporation v. F.C.C., No. 81-1052 (D. C. Cir., filed January 16, 1981).

Second, the creation of an FSA will require considerable regulatory attention to insure that all of the separations required between the dominant regulated carrier and the FSA are maintained. The FCC and the competitors of the FSA will share a burden of continually monitoring the activities of the FSA to insure that it is operating in the prescribed manner.

If Congress elects to resolve the problems of cross-subsidization through the creation of an FSA, far more stringent separation accountability than those currently included in S.898 must be incorporated into the legislation. For example:

1. The division of services between the FSA and the rest of the Bell System should be drawn at the exchange/interexchange boundary, with the FSA limited to interexchange services. Any other division such as placing all "enhanced", "information" or "competitive" services in the FSA will result in disputes over whether each new service AT&T wishes to introduce properly belongs in the FSA or dominant regulated carrier.

2. Partnerships, joint ventures or other business arrangements between the FSA, and other members of the Bell System or the dominant regulated carrier should be put on public notice for a period of thirty days. This would provide an opportunity for other carriers to scrutinize the arrangement and insure that it was not a means of subsidizing the FSA's rates. Carriers should be permitted to file comments with the FCC if they believe the arrangement to be anticompetitive. No such partnership, joint venture or other contractual arrangement should be permitted to go into effect if at the end of the thirty day period, adverse comments have been filed, unless and until the FCC determines on the record before it that the arrangement is not anticompetitive. The current language in S.898 permitting the FCC to make such agreements available to the public is insufficient protection against cross-subsidization.

3. The FSA must be prohibited from owning local transmission facilities. Part of the goal of establishing an FSA is to ensure fair interconnection for all long distance carriers. If the FSA is

permitted to own its own local transmission facilities a strong incentive for fair and reasonable access would be eliminated.

4. Legislation should provide clear guidelines for the valuation of assets to be transferred to the FSA. The valuation should be made by the FCC, rather than a special board which could be dominated by the member appointed by AT&T. (See §228(5) of S.898).

5. The legislation should impose a reasonable ceiling on the amount of capital AT&T may contribute to the FSA in any one year. Without such a limit the FSA will be able to provide services at a loss and make up the lost revenue through capital contributions from its parent. The FCC should be authorized to review all capital contributions to ensure that such contributions are not used to subsidize below cost rates for services provided by the FSA. Additionally, the dominant regulated carrier and all other members of the Bell System should be precluded from loaning funds to the FSA or guaranteeing repayment of funds the FSA borrows from third parties.

6. The Bell System should be permitted to own no more than 70% of the FSA. This would provide extra levels of review by the SEC and by non-AT&T owners.

7. Movement of employees between the FSA and Bell System should be more severely restricted than is required by S.898. No employee should be transferred between companies more than once and officers and directors of the FSA should be precluded from serving another member of the Bell System in any capacity.

The Bell System will undoubtedly argue that the imposition of restrictions such as those I have set forth will result in inefficies and a loss of economies of scale to the consumer in both price and service availability. There may well be a loss of some economies, but the nation will gain more from a dynamic, competitive industry then it will lose by giving up some efficiencies of verticle integration.

Even if Congress adopts all of the restrictions on activities between the FSA and other members of the Bell System which I have proposed, as well as those currently contained in S.898 and proposed by other industry members, I am not confident that an adequate system of accountability will have been established. The FSA will remain as a member of the Bell System and there may still be the opportunity and incentive to cross-subsidize some, if not all, of the services it provides. Therefore, the legislation should include a provision permitting the FCC to alter the relationship between the Bell System and the FSA as required to fulfill the goals of the legislation. This continuing oversight should include the authority to require the Bell System to sell all or a portion of its ownership interest in the FSA.

III. CONCLUSION

New technologies such as wideband satellite data transmission, advanced terminal and switching equipment, and a regulatory environment more favorable to competition, have brought about considerable change in telecommunications industry in the past ten years. During this time the telecommunications industry has also received a significant amount of legislative attention as Congress strives to fashion communications legislation for the 1980s and beyond. The restructuring of an industry in which one company -- AT&T -- is the dominant force in a complex undertaking and one which this Committee, with its particular area of expertise, should carefully examine before any legislation is passed.

Thank you for this opportunity to testify. I would be glad to answer any questions you may have.

MONOPOLIZATION AND COMPETITION IN THE TELECOMMUNICATIONS INDUSTRY

FRIDAY, JULY 24, 1981

U.S. SENATE,
COMMITTEE ON THE JUDICIARY,
Washington, D.C.

The committee met, pursuant to recess, at 10:05 a.m., in room 2228, Dirksen Senate Office Building, Hon. Strom Thurmond (chairman of the committee) presiding.

Present: Senators Thurmond and Mathias.

Staff present: Marcy J. K. Tiffany, antitrust counsel and economist; Stephen Cannon, antitrust counsel; Ralph Oman, chief counsel, Criminal Law Subcommittee; and Herman Schwartz, minority counsel.

OPENING STATEMENT OF SENATOR CHARLES McC. MATHIAS

Senator MATHIAS [acting chairman]. The committee will come to order.

This is the fourth in a series of hearings that the Committee on the Judiciary is conducting on the subject of monopolization and competition in the telecommunications industry.

Yesterday the committee heard testimony from a number of witnesses who expressed concern about the state of competition that presently exists within the industry. Several of these witnesses indicated that the structure proposed in S. 898, the Telecommunications Competition and Deregulation Act of 1981, does very little to make sure that we have active competition in the industry.

This morning, the witnesses will include representatives of A.T. & T. and some of the other parties who generally favor the proposed legislation. I anticipate that they will explain why, in their view, this legislation may be necessary. This will enable us to obtain another perspective on the adequacy of the provisions governing fully separated affiliates to insure against anticompetitive activity.

The first panel this morning includes Mr. Morris Tanenbaum, the executive vice president of A.T. & T., and Mr. Howard J. Trienens, the vice president and general counsel.

Gentlemen?

STATEMENT OF MORRIS TANENBAUM, EXECUTIVE VICE PRESIDENT, A.T. & T., NEW YORK, N.Y.

Mr. TANENBAUM. Mr. Chairman, I am Morris Tanenbaum, and this is Mr. Trienens, as you know.

We appreciate the opportunity to appear here today. We filed testimony, and with your concurrence I suggest that you permit each of us to present a rather brief summary of our statements. Then, of course, we remain available for whatever questions you would like to ask.

Senator **Mathias**. Without objection, your full statements will be included in the record after the panel discussion, as well as such brief remarks that you wish to make at this time.

I believe that not all members of the committee received copies of your written statements until some time late yesterday. Under those circumstances, I would ask that you remain available to answer questions, perhaps on some other occasion or perhaps in response to written questions that might arise as a result of the members' perusal of your statements.

Mr. **Tanenbaum**. We would be happy to do that.

Senator **Mathias**. Fine.

THE NEED FOR LEGISLATION

Mr. **Tanenbaum**. If I may begin—and Mr. Trienens will follow me—over the last decade or so there has been a distinct public policy shift toward competition, as you know, reflecting, we believe, a high degree of confidence on the part of regulators, Government policymakers, and the public that competition in the marketplace would best serve the Nation. Communication common carrier regulation has tried to keep pace with that movement of policy.

Regulators have worked to stimulate and meld the rapidly growing competition within a regulatory framework which never contemplated the free exercise of marketplace forces and the enormous technological evolution of the 1960's and 1970's.

The Communications Act of 1934 is just not adequate to cope with the environment of the 1980's and the 1990's.

An authoritative restatement by the Congress of that policy can open the way to a new era of accomplishment on the part of the telecommunications industry; and ours will be a better, stronger, and more productive Nation as a consequence.

Although it foreshadows massive and very difficult changes for us in the Bell System, we are encouraged by the action which the Members of the Congress are taking to address this important question.

Current litigation also seeks to address this question; but we are in agreement with former Attorney General of the United States, Griffin Bell, who stated before your colleagues of the Commerce, Science, and Transportation Committee on June 16:

> Questions of the magnitude posed by the American Telephone & Telegraph litigation should be reviewed by Congress in a broad context. The legislative process is singularly appropriate for situations like this which require a balancing of almost unlimited social, economic, and policy concerns extending beyond the scope of the Federal antitrust laws.

The issues being raised by these hearings have been addressed in a number of forums over the last decade and a half. Indeed, they have been reviewed by each arm of the Government with responsibility and expertise in this area.

S. 898

Senate bill 898 represents a comprehensive revision of the Communications Act. Through reliance on competitive forces it seeks to maximize the opportunities that are presented today to our society and economy in the "information age."

In fashioning a structure within which A.T. & T. and, indeed, the entire industry could best meet the purposes of S. 898, a compromise solution has been reached, a solution which includes massive reorganizational burdens on the Bell System.

The solution contemplates two separate and distinct technologically integrated entities within the Bell System. Howard Trienens will be addressing in greater detail the adequacy of the structural separation requirement in S. 898 in just a few moments.

A.T. & T. STRUCTURE

If you would permit me, I would like to set the stage for that by discussing the current structure of the Bell System and how the organizational form has allowed us to served the Nation's telecommunications needs for over a century.

History has shown that the provision of telecommunications service is enhanced through what is called the total systems approach. Within the Bell System this total systems approach is embodied in an integrated organization.

A.T. & T. is the parent and provides policy as well as detailed day-to-day guidance in the development of technology and customer services.

The fundamental mission of Bell Laboratories is to assure that the Bell System will have available the knowledge and technology essential to meeting the Nation's current and future communication needs.

Western Electric is the Bell System's manufacturing and supply unit and, as such, is managed in the interests of the service requirements of the operating companies and Long Lines; and the 23 Bell operating telephone companies concentrate on local and regional telecommunication service needs.

Long Lines is the operating arm of A.T. & T. It constructs, maintains, and operates the long-distance network which interconnects Bell as well as the independent telephone companies. In effect, Long Lines serves as a managing partner coordinating the growth of the interstate network.

The total mission is to serve; and to fulfill that mission the service process must be a continuous one extending uninterruptedly from the creation of knowledge to invention through development, manufacture, and supply, to customer service.

In light of this mission and the demanding nature of the telecommunications network, the benefits of a technologically integrated structure become clear.

The primary benefits of Bell System integration to the individual units and—more importantly—to the telecommunications users are these:

First, it does permit a total systems approach to telephone service. Planning, research, invention, design, development, manufacture, and operations are directed toward the single objective.

Second, it assures the necessary compatibility, reliability, and quality of equipment needed for optimum network function.

Third, it facilitates and speeds innovation in the complex, interdependent network. It assures that the demand for telephone equipment and service is met quickly and reliably, and it provides substantial cost advantages.

In addition to the many other economies the Bell System achieves through integration, Western Electric's prices for telecommunications products average about 16 percent below those of the lowest general trade supplier, thereby providing substantial savings to the Bell-operating telephone companies.

I think the results speak for themselves. This Nation has the largest, most advanced, and efficient telecommunications network in the world. Thus, I think it is clear that the approach we have taken in this country works and that it works well.

The factors which have led to the Bell System's structure are not unique to this country. Although the U.S. network is significantly larger and more advanced than those of other countries, the problems faced by foreign telephone administrations are not basically different from our own.

Other nations have approached the problem in a variety of ways. Some closely parallel to the Bell System. Sweden and the eastern Provinces of Canada are served by organizations with integrated structures very much like the Bell System, and Japan has its own unique form of integration. Not coincidentally, the service they offer is among the best outside the United States.

It is also of interest to note that the electric power industry which for decades depended on nonintegrated suppliers for its research and innovation has, with the encouragement of the Congress and the regulatory agencies, established EPRI—the Electric Power Research Institute—and thereby moved in the direction of a more centrally directed technology.

Paradoxically, while voices both here and abroad argue in favor of greater integration so as to effectively develop and operate complex systems, others appear to call for fragmenting the integrated structure of the Bell System.

Such fragmentation would not only undermine the Bell System's ability to continue its outstanding performance, but it would also effectively destroy the structure in which Bell Laboratories and Western Electric as a team have functioned as an important national resource.

The need for teamwork between Bell Laboratories and Western Electric today is actually intensifing as the subtleties of development, design, and manufacture have become more closely joined.

Good examples of this are the sophisticated design and manufacturing processes used to produce very large-scale integrated circuits [VLSI] the tiny silicon chips that are the foundation of today's telecommunications and information processing systems.

The Bell System's structure is neither arbitrary nor a relic of earlier outdated conditions. It is instead a living, continuously evolving arrangement of elements that reflects our best efforts to conceive, develop, install, and operate an efficient and modern telecommunications network.

THE BENEFITS OF TECHNOLOGIAL INTEGRATION

It is most important to appreciate that this structure is designed to serve the technological imperatives of the network, and not the other way around.

The telephone network is the most complex interactive assemblage of electrical and electronic equipment that exists in the world today. The complexity of the network and the daily demands placed upon it require a degree of coordination and compatibility among its parts and functions which far exceeds that required by any other industry.

Because of its complexity, size, and the critical services the network provides, each of its parts must be reliable to an extraordinary degree.

Again, formal specifications of end-point requirements are often inadequate. Reliance must be placed on detailed understanding and control of manufacturing processes and materials and on the rapid response of design and manufacturing engineers to incipient or actual field troubles.

An example of the requisite reliability can be found in telephone switching. Electronic switching equipment is designed to operate trouble-free for all but 2 hours of its 40-year service life, a requirement far more stringent than that of general purpose commercial computers.

It is the requirements of compatibility and reliability as much as any of its other characteristics that set the telephone network apart and mandate the technological integration of the Bell System.

The Nation's telecommunications industry has been subjected to continuous turmoil throughout the last decade. The Congress has recognized that statutes established in a different technological era are not adequate to cope with telecommunications in the present and the future. Therefore, the Congress has sought to enact legislation reforming the law to establish the appropriate future structure, the future goals, and the future guidelines for the industry.

During this period the Department of Defense has consistently advised the Congress of the significant adverse impact a breakup of the Bell System would have upon national defense and security and emergency preparedness telecommunications needs.

There are compelling technological, economic, and service imperatives to technological integration in telecommunications and well-documented benefits to our customers.

Technological integration has enabled the Bell System to build the best network in the world. This same structure will be critical in the future if the Bell System is to compete fairly and effectively with many technologically integrated firms entering the telecommunications market in this country.

Large, technologically integrated Japanese, Canadian, and Western European companies have targeted the U.S. telecommunications and information processing markets for concerted attack.

Integrated enterprises in the United States are largely responsible for the leadership the United States currently enjoys in the technologies of the information age. This leadership will be seriously jeopardized or completely lost if, as some have advocated, our most productive technologically integrated enterprises are structurally dismantled.

In short, the technologically integrated Bell System remains unequivocably essential to the best interests of the telecommunications industry and the Nation.

Mr. Chairman, we appreciate the opportunity the committee has afforded us to help you focus on the issues being addressed today, and following Mr. Trienens' statement we will be ready to respond to any questions you have.

Senator **MATHIAS**. Thank you.

Mr. Trienens?

STATEMENT OF HOWARD J. TRIENENS, VICE PRESIDENT AND GENERAL COUNSEL, A.T. & T., NEW YORK, N.Y.

Mr. **TRIENENS**. Thank you, Mr. Chairman, for this opportunity to be here.

Without reading the statement I have submitted I do want to emphasize that Dr. Tanenbaum has described the network that serves this country, serves it well, and with a productivity record that results in rates going up at about half the rate of the cost of living. We are proud of that performance. I think Dr. Tanenbaum has explained why that has happened.

Before addressing your question—Why is legislation necessary?—I would like to describe the alternative that has been set before this committee.

DIVESTITURE IS UNWORKABLE

The alternative is divestiture. Some of the witnesses come out and say that is what they want. Some of them come out and say: "Oh, don't pass any bill now because there is a court case pending, and we ought to wait."

Some of the urgencies of foreign competition and some of the realities of the fast pace of this technology do not permit you to say: "Well, let's wait; 5 years from now we will read the Supreme Court opinion, see how this came out, and then see whether there ought to be legislation."

LOCAL EXCHANGE ISLANDS ARE IMPRACTICAL

The alternative to divestiture also sounds very abstract, and we ought to understand exactly what is being asked for—I mean precisely what the Antitrust Division asked for in court last June. It is to create islands of local exchange networks separated from each other both in ownership by A.T. & T. and with ownership of any intercity communications.

More specifically, they suggest and specifically pray in their relief proposal—one adopted by witnesses before this committee—that the Bell operating companies be sold and reconfigured so that all they have left is the local exchange.

To put it in terms of the chairman's State, Baltimore would be one island of local exchange; Hagerstown, another. The company—C. & P.—would own those two exchanges and the other islands. They would not own the terminal equipment; that would be pulled out into another organization. They would not be entitled to connect their own exchanges; that is intercity; that would be off with another organization.

These islands, which constitute about two-thirds of the Bell System's investment, would be out there separated from each other, with the network thereby chopped physically and by ownership at the exchange border.

The exchange border is important. We should have cost allocations for it; accounting can be done; but the network Dr. Tanenbaum described is designed as one, managed as one, as an integrated network.

These switching machines that are so critical to the network do not have labels on them in one building that says "intercity" and another that says "local." They are the same buildings and the same machines.

The cost of tearing this apart would be enormous. Even worse, the cost of engineering these separately, suboptimizing the efficiencies which the country now enjoys, would be continuingly enormous. It would simply destroy the network that has served this country so well.

Who is for it, besides some of our competitors who would like to destroy the network with which they compete? Has there been a single Congressman or Senator who has come out and said: "That is what I propose"? If they said that—if a majority of the Congress thought it through and said it—that would be the policy for this country. No one says that.

They do say things like: "Oh, let's not rush into a bill that has been studied for only 6 years; let's not do anything while there is a court case going." But they never face up to exactly what these people are talking about and whether they want it.

If you want it, you want it, and let us pass it. If you do not want it, you should not let it happen by drift.

I would emphasize that, although they talk about divestiture and the relief that is involved, there are other legal problems that are clouding up this industry and making it impossible for engineers, scientists, and businessmen to plan in this country. It is not just the Bell System but the entire industry.

THE IMPACT OF COMPUTER INQUIRY 2

We are under an order right now, effective last July, under which we, the Bell System, will have to move 150,000, employees and over $10 billion of plant, all that terminal equipment, over to a separate subsidiary. This is the FCC order in what is called computer inquiry No. 2. That order is very difficult to comply with in terms of the logistics.

The Bell System, with the order outstanding against it, is complying. It does provide for a separation so that the terminal equipment area can be handled on a more competitive basis—a detariffed basis.

Competition is here. This legislation before Congress does not create this competition; it is here. The question is how to deal with it fairly, how to deal with it efficiently, and how not to artificially exclude competitors.

The computer inquiry No. 2 upon which all this effort is being based is in court. It is in the court of appeals here with many parties attacking it on numerous issues, all of which Congress can decide: Do they want the FCC to have jurisdiction over the terminal equipment rates or do they not? Do they want the States to have jurisdiction or do they not? These are matters that the Congress can clearly and without any attack decide.

The 1934 act does not give you much guidance. People are up there in the D.C. circuit in 1981 arguing about whether the 1934 act contemplated the sort of technology we have got today. It did not. So what do you do? You have judges operating in a vacuum without any policy guidance from this Congress?

THE 1956 CONSENT DECREE

One more ring in this circus is that we have got a consent decree—a 1956 consent decree that assumed that regulation was an area you could define, and within that area the Bell System would operate, and outside that area would be deregulated.

What has happened is that through the influx of competition—both intercity and terminal equipment—the premises have been destroyed, not by the Bell System but by the FCC and the technology which has really broken down the line between computer and telephone. Technologically, it has just destroyed the distinction that seemed valid in 1956.

So what has that got to do with our problem? What it does is detariff the terminal equipment business—this 150,000-employee business we are talking about.

Can the Commission do that? Well, one question is: Can they do it under the Communications Act? That question is in the D.C. Court of Appeals.

Another question is: If it is detariffed—not deregulated, which is a different form of regulation—is it still something prohibited by the 1956 consent decree which talks about a common carrier service subject to regulation? It does not say, "subject to tariff regulation," just "subject to regulation."

So we lawyers are up there in New Jersey. On our side—I say "our side," but the FCC interpreted it and NTI of Commerce interpreted it the same way, and the Bell System agrees with them. So what do we have?

We have the U.S. Government squabbling with itself, with the Department of Justice saying: "Oh, no, I read the thing differently. It is as though it said 'tariff' in there."

There are 14 platoons of other interests, mostly competitors, with their New York lawyers, their Washington lawyers, and their New Jersey local lawyers, all swarming over the court and litigating a matter which is a matter on which Congress really ought to make the policy.

I am not lacking in confidence as to how that ought to be interpreted. What I do know is that if we win it in the district court then we will be in the third circuit, and then we will be in the Supreme Court, and so we will have another couple of years of litigation.

LEGISLATION IS NEEDED

The question is on creating a balance. Do you want the network that is so important to this country's telecommunications service to continue? If you want that and competition—and I think there is a consensus that competition is wanted—how do you create structural safeguards so you can have it both ways?

We think the bills that have been through Congress—both the House last year and through the Senate Commerce Committee this year—have elaborate safeguards—too elaborate, from our point of view. They are all laid out in the appendix to my statement.

Our view is that they are more elaborate than they have to be; but that is a balance of safeguarding it and having something that preserves the network and, at the same time, maximizes competition and, most of all, provides some ground rules under which the businessmen of this country can, instead of fighting the Federal Government, spend all their energies competing with the foreign interests who are more than happy to come in here and take over this market while we are squabbling among ourselves with the Federal Government.

Thank you very much, Senator.

COMPETITION VERSUS THE TOTAL SYSTEMS APPROACH

Senator **Mathias**. Thank you, gentlemen.

Mr. Tanenbaum, in your statement you emphasize the benefits of what you call the total systems approach. Our whole economic philosophy, however, involves the concept that competition is the best measure of the efficiency of your economy. How do we reconcile the total systems approach? Mr. Trienens suggested that in his judgment the bill does provide you with both the advantages of the system plus a measure of competition. How do you feel about that?

Mr. **Tanenbaum**. It is a difficult and complex question, and I think that is the reason the Congress has taken the time that it has—some 6 years now—to try to deal with that and explore all the possibilities. One must strike a proper balance.

From our point of view, S. 898 strikes a workable balance. We would have struck the balance elsewhere, quite clearly, as we have discussed with the Congress; but we believe S. 898 does strike a workable balance which permits the basic underlying network to continue to be operated and managed as one but also guarantees that access to that network will be open to anybody at nondiscriminatory charges that permit customer-premises equipment to be supplied only—from the Bell System point of view—by an affiliate which is completely separate—separate in many, many ways—from the regulated part and again permits anyone to connect their terminal equipment to that basic underlying network, the same way that the Bell System affiliate does.

Through all of this consideration I think the Congress takes the view that competition should be injected into this market wherever it can be, while at the same time preserving the basic underlying network, so that everyone in this country can have at least basic telecommunications service reasonably available and so that the other important organizations in this country, such as the Department of Defense, can have a network that it can rely upon for national security and emergency conditions—so that you can have both of those with adequate safeguards between them.

Senator MATHIAS. Both of you have pointed out the fact that competition already exists. If that is true—if the fact is that enterprises can come in and compete today—why is it not equally true that the Bell System, which has far greater resources than any individual competitor, is not in just as good or better a position to compete in a freer economy and a freer market situation?

Mr. TANENBAUM. The principal reason for that is that the Bell System is under very special kinds of regulatory constraints, consent decrees, and things that have grown out of this era when everything was fairly heavily regulated while the other competitors are under altogether different conditions.

Howard, perhaps you would like to address that more explicitly.

TECHNOLOGY AND FOREIGN COMPETITION

Mr. TRIENENS. The question really is: If you believe in deregulation—as I think the Congress railroad statutes and those in the airlines and trucking other areas attest to—does it make any sense, particularly in an industry where you have foreign competition, domestic competition, and no barriers to entry, to continue to have one of the competitors subject to a tariff-type, cumbersome set of regulatory hearings in 48 States? Is that the way to have one competitor compete against the Japanese? It does not make sense.

Talking about size and dominance, in terms of sales in the terminal equipment area, which is the emphasis for the Computer Industry 2 as to the current order, it does not make any sense. It is just an unnecessary regulation and unnecessary ways for the competitors to squabble with each other before all these different commissions. For what? It does not make any sense.

Senator MATHIAS. Where were you when I was trying to muster support for a look at the effect of our own antitrust laws on the U.S. economic position in the larger world in which we compete today? I needed you at that time.

Mr. TANENBAUM. We are sorry we were not there.

Senator MATHIAS. So am I.

I must say, I am very responsive to the proposition that technology has changed the world, that technology has had a revolutionary effect on the economy of the world, and that the antitrust laws of the United States do not always reflect that extraordinary turnover. I think it is time we took a look. What we do in the way of changes is something else again, but we should at least carefully examine how the law on the books today conforms to the reality of life today.

Mr. TRIENENS. As to your point on why do we all think differently, we have all grown up under the 1934 act which had as its premise that there would be barriers to entry, that competition in certain types of areas was wasteful, duplicative, and not in the public interest. We all grew up under that. That was the law, and the statute has not been changed.

During this period of regulatory turmoil there has been an injection of competition in large doses in the intercity area and particularly in the terminal area.

The Bell System was endeavoring to balance between not only the Communications Act as it understood it, but 70 percent of the Bell System is regulated by States, and we were in an internecine warfare with the State commissions not wanting this competition which would affect drastically the realities of their freedom to adjust rates for their own social purposes.

Seventy percent of our business was regulated by people who did not want this to come and 30 percent by a commission which took fits and starts in going in this direction, and it really was not until the last couple of years that this has been recognized—that this is the way.

There is a consensus that this is the way Congress wants it, and the only thing that is stopping you now is how you work out the balance. It has been in just the last couple of years that this consensus has emerged. It is too bad it did not all come in 1969 and we all had the ground rules at the beginning.

NETWORK MANAGEMENT

Senator **MATHIAS**. You pointed out that the success of the system today depends to a certain degree on some interplay—some cooperation—of all of the components of the system. That is right.

Mr. **TRIENENS**. In terms of the interplay of the local and intercity, it is one network—managed as one and designed as one. As far as the interplay of the so-called manufacturing and so-called research facilities is concerned, even stating them separately misstates how they really operate.

As Dr. Tanenbaum has explained, this is one system which is technologically integrated so as to get an idea out into the field in the quickest and the best way, and these are simply mechanisms for doing it. They not only interact; they are one total system working together. That is how they get the productivity they do.

Mr. **TANENBAUM**. I think in many ways this is not unique in the Bell System or any other high technology organization. The literature is full of case studies, management studies, and case histories on getting a new invention out in the marketplace properly tailored to the marketplace, and particularly in technologies where designs turn over every 2 or 3 years. So you must have a continuous flow of it.

One aspect that is unique in the telephone network—ours as well as anybody else's—is that every part of it is physically connected to every other part of it—that is why it works—so that a message anywhere in the country can be connected to someone else anywhere in the country and indeed in many other countries.

So compatibility is absolutely essential. Otherwise, the network just will not work. When you have these double demands which are unique to telecommunications, the need for the ability to work together, to plan together, and to solve problems together is just absolutely critical.

Senator **MATHIAS**. I think this is an interesting area because it is where the state of the art may be in conflict with the state of the law. If this interplay is essential to the operation of the system, is there not at the same time some conflict with the concept that the fully separate subsidiaries are equal competitors with independents in the marketplace?

CONCERN RE CROSS-SUBSIDY

Mr. **Trienens.** I do not believe so. This is what happens here: What the great concern is and what all these structural safeguards and all these separate provisions are all about is the fear of cross-subsidy. The fear is that there will not be fair competition because somebody is somehow slipping money under the door to subsidize predatory rates or something else—whatever that fear may be.

It is one thing to divorce, separate, or divest, and say the Bell System cannot be in the terminal business or cannot be in this business or that business and therefore deprive the country of a competitor who is really the greatest innovator of them all. It is another thing to say: "All right, if you are worried about cross-subsidy, let us not get emotional about size and the fact that they are doing something else; let us be sure there is no cross-subsidy."

You should look at these myriad of safeguards and say: "Does it stop cross-subsidy?"—which is the worry we have—if that is your worry. Once it stops the cross-subsidy the fear of unfair competition ought to vanish.

Mr. **Tanenbaum.** Another way to look at that also is: Does this bill really produce those separations? This means that our fully separated affiliate can no longer work in the same way as it has in the past with the rest of the Bell System. If you follow my thesis, you say: "Yes, that is somewhat negative."

However, what is positive about it? The positive thing about it—clearly in the eyes of the House subcommittee last year and the Senate committee this year—is the fact that it is a way to inject more diversity and more competition.

The clear conclusion of the Congress—at least at this stage, as far as it has gotten—is that that outweighs the other problems that you have created by breaking this close interconnection, but you have to be very, very careful where you do it, and that is what much of the argument and discussion has been on.

It is our opinion that the Congress, through all of its work and its wisdom, has reached some places to make those breaks in a way which will be workable.

Senator **Mathias.** You are the first person around here for a long time who has referred to the "wisdom of Congress." I thought that was a totally outworn concept.

MINORITY OWNERSHIP

While we are on the subject of cross-subsidization, given the difficulty that the FCC has encountered in attempting to review your cost accounting, do you think it would be of any value to have some small percentage of outside ownership to provide an additional overseer of the affiliate activities?

Mr. **Trienens.** No; that would be not only an unnecessary complication of the structure, but it would be, in effect, a partial divestiture.

Senator **Mathias.** I interpret that as a kind of a visceral answer.

Mr. **Trienens**. Well, we have made elaborate studies of it. We have had separate subs before which had partial minority ownership. They do not affect the fact that you control it; they do not affect what you should be doing with it; they are simply an unnecessary complication. What is worse, from a lawyer's point of view, is that it gives a little basis for people to sue you.

We have had some experience with that. We have been sued in a case. This was back a ways. The minority stockholders in Pacific Co. hired a lawyer to sue us because Western Electric prices were too high. Others had a little sliver of Western Electric minority stock, and the Western Electric minority was saying:

> Because you are all part of one system we are being hurt because your Western Electric prices are too low; you are not maximizing the profits of my corporation.

So, we had both of those suits. They were both wrong, but we have spent 5 years litigating with both of them. Who needs that?

Mr. **Tanenbaum**. Further to your point, the bill, of course, does require that this fully separated subsidiary have a complete accounting system that meets all of the standards of any other competitive company. Those standards will be subject to audit and will be audited, both internally and externally; and, of course, the stockholders of A.T. & T. represent a very broad segment of the public and have the full stockholders' rights to whatever audit information and financial information that public stockholders have, which will include those of the fully separated subsidiary.

Again, that seems to be an area that has been addressed, and adequately addressed, in S. 898.

IMPACT OF DIVESTITURE ON BELL LABS

Senator **Mathias**. Let me confess a bias at this point. It is a current custom that we have to make disclosures. I have to say that I have been a great admirer of Bell Laboratories for many years.

I was interested in the fact that you mention in your statement that divestiture would likely result in a massive fragmentation of Bell Laboratories. Explain to me the relationship between divestiture of a local exchange facility, which is what Justice is talking about, and this devastating effect on Bell Labs.

Mr. **Tanenbaum**. As Mr. Trienens has pointed out, from a technological point of view—a scientist's or engineer's point of view—there really is no break between the local exchange network and the intercity network. That break is purely the creation of regulatory procedure, regulatory jurisdiction, and the way rates are set. The network is totally integrated. The same machines switch both kinds of traffic. The same transmission facilities carry both kinds of traffic within the same cable sheath, within the same channels.

To break that in half essentially would mean either one or the other would have to forego doing its own technological integration or fully duplicate it. That would not only be a massive expense, but it is unclear in my mind that you could create two organizations of the competence of Bell Laboratories within less than another 100 years. Organizations of that sort are built only very slowly, at great expense, and over a long period of time.

So that kind of divestiture would really fragment, and fragment in an artificial way from an engineering point of view, the whole research, invention, development, and the whole innovation process.

INTERCONNECTION ISSUES

Senator **Mathias**. Mr. Trienens points out that under the provisions in S. 898 that deal with the problem of cross subsidization, the requirement of equal access to local distribution facilities is laid down.

Mr. **Trienens**. Equivalent access.

Senator **Mathias**. Originally section 222 required equality, not equivalence. Is that right?

Mr. **Trienens**. If you look at the reality as to how you do it, it has got to be essentially equivalent.

Senator **Mathias**. The Commerce Committee bill has now changed that to require equitable treatment.

Mr. **Trienens**. That is right, and that is the way it should be. Without divestiture that is the only way you can do it.

Senator **Mathias**. Of course, "equitable treatment" is a much more flexible term than "equal treatment."

Mr. **Trienens**. Oh, yes; let me give you an example of how it would work. Unless you just totally divest and physically get everybody out of the building—what if a company wants to colocate a switch, meaning there is a toll switch in a building and a local switch in the building and a competitor wants to put a switch in the building? Do you have to build another building?

How would you possibly be able to have absolute, total equality without just simply divesting them, physically cutting them apart, and then saying: "All right, nobody gets in the building or everybody gets in the building." Of course the answer would be that nobody would get in the building.

There is no way you can carry this out. These people have carried it one step farther and farther. There is no way you can have an integrated network and have equal treatment in the literal sense where they can come into the building and say: "Well, Long Lines has got a switch in the the building; why can't I?" And if he can have one, why cannot three other people have one?

Senator **Mathias**. What you are saying is that A.T. & T. would have to object to amending S. 898 to return to the standard of equality?

Mr. **Trienens**. Yes, and in deciding those terms—which sounds like we are arguing over semantics—just figure out what you want us to do with those buildings, what you want to do with the network, and whether you want to break it up. It is just a practical problem. It is not a semantic or philosophical problem; it is: "What do you do with the building?"

Senator **Mathias**. It is a bricks-and-mortar problem.

Mr. **Trienens**. It is whether you want an integrated network or whether you want to pull it apart—to pull it apart at terrific cost and lose the benefits of the integrated network. That is the gut question.

FULLY SEPARATED AFFILIATES

Senator MATHIAS. If this legislation is enacted, how many fully separated affiliates would you expect to be created?

Mr. TANENBAUM. Let me try to address that one. The bill mandates at least two new kinds of fully separated affiliates, one of which has customer-premises equipment and enhanced service and another which has certain kinds of information services—electronic information services, as they are typically called. Without question, we would plan to establish those.

To what degree we might further subdivide is really unclear to us right now. Every time you create another affiliate you create new overheads, new reporting requirements, new sets of officers, and so on; and that costs you money.

So you have to see some economic management benefit that fully offsets that and, in fact, more than offsets that. I think that is the kind of thing that you really learn with time.

Never having operated with these two new kinds of affiliates before, we are undoubtedly going to need to get some experience with that before we decide what our optimum structure will be under S. 898.

Senator MATHIAS. Regardless of the number of affiliates you would create—and I understand why it is difficult for you to give us an exact estimate—under S. 898, would not A.T. & T. management direct most of the activities of the affiliates?

Mr. TANENBAUM. Yes, we would certainly manage it—manage it as the owners, with fiduciary responsibilities to stockholders. We would certainly manage it, and the bill recognizes the need to do that.

Mr. TRIENENS. There is a balance here, and this is not divestiture; it is designed to stop cross subsidy, as I said. Let us look at some of the things this does.

For example, because there is an FSA a customer will no longer be able to go to the telephone company and order a telephone and service. He will go to the C. & P. Telephone Co. and say: "Well, I have got a new home, and I want some telephone service"; and they will say: "Yes, we will give you a dial tone; we will give you a wire into the house and some plugs." So he will say: "What about my telephone service?" They will say: "You will have to go somewhere else." "Somewhere else" will be a number of places, one of which will be this FSA.

That kind of thing is costly; it is a burden on the public; it is one of the things that is thought necessary, not just by S. 898 but by the Commission in its computer 2—that that is one of the things they ought to do just to be abundantly clear beyond mere accounting systems that there is an absence of cross subsidy.

Even with all that, it does not say that there ought not to be management. It does not say that there ought to be divestiture because when you think about it divestiture does not make any sense.

So it is a balance, and it is a balance which already is very onerous and does some things that the public is going to wonder about when they find out what is really happening.

FCC COSTING STANDARDS AND THE USOA

Senator **Mathias**. During the course of these hearings, the committee has received testimony which is to the effect that the FCC today has not been successful at accomplishing the cost analyses of the A.T. & T. rates, and on this ground has invalidated some of the rates.

Mr. **Trienens**. Yes, sir.

Senator **Mathias**. The prior testimony also indicates that after several years of trying, A.T. & T. has not been able to formulate a workable, uniform system of accounts.

So the question at least comes to mind as to how the Commission is going to be able to establish an accounting system within a year, as required under S. 898.

Mr. **Trienens**. The regulatory history you speak of is true in the sense that the Commission did find certain of our rate filings "unlawful." That was before the court of appeals here a year ago. The court of appeals said that was wrong of them to call them unlawful.

What they meant was that, the Commission not having made up its mind on what the standard ought to be, the Commission was not satisfied with our cost as showing the rates were either too high or too low. They were not satisfied with the cost standards that were being employed.

Therefore, the court said, it was wrong—it was mere rhetoric—to call those rates unlawful because they did not know whether they were unlawfully high and they did not know whether they were unlawfully low, and the Commission ought to make up its mind on what the standard ought to be.

The victims of this lack of a standard, they said, included the Bell System. We are not the beneficiary of that; we are not the villain here; we are the victim.

Why is there this turmoil where they cannot make up their minds on the standard? One of the reasons is that they were trying to be protective. They did not want an antitrust standard; they did not want an economic standard; they wanted a protectionist standard; they wanted fully allocated costs. They went to method 1, and then to method 7, and then back to method 1.

The reason for the problem is that they did not make up their mind, and A.T. & T. cannot make up its mind on what its uniform system of accounts is going to be because the uniform system of accounts under which we live, which we obey faithfully—and we have as good an accounting system as anybody in this world, but the accounting system is dictated by a uniform system of accounts prescribed by the FCC in its rules.

This Congress is telling them: "You prescribe a system of accounts." All they have got to do is prescribe one in this era of competition, one that does not try to protect everybody, one that provides whatever detail they want, and we will produce it for them. We are the victim of this turmoil; we are not the creator of it.

Senator **Mathias**. The question really is: Are they going to be able to write the prescription?

Mr. **TRIENENS**. An act of Congress will be a very therapeutic thing in getting some action on this subject.

Mr. **TANENBAUM**. It has been a question not so much of ability but of making decisions—deciding what they want.

Senator **MATHIAS**. This has been an invigorating experience to come here today. Mr. Tanenbaum attributes wisdom to the Congress. Mr. Trienens attributes efficacy to their actions: We can order it, and it will happen. This is very novel in this day and age.

Mr. **TRIENENS**. It is something Congress has not tried since 1934.

Senator **MATHIAS**. Let me just ask you one more question. One of the complaints, of course, goes back to this question of the number of affiliates that you might set up. One of the complaints is that if you set up only a limited number of affiliates, each one of them would be of such economic mass that they would be a far from equal competitor from the average kind of independent company in that particular branch of the business. Therefore, it is argued, there ought to be some formula—geographical, perhaps, or if not geographical maybe related to size of market—that would govern the number of affiliates you would set up.

Is there any validity, in your judgment, to that kind of complaint?

Mr. **TANENBAUM**. I do not believe there is, Mr. Chairman. You have to look at who the players in this game really are and who one expects them to be. I will just tick them off for you—the people who have announced their intention or are actually in this business. They are: Exxon, IBM, RCA, Xerox, the Japanese, either in terms of individual companies or the kind of combines——

Senator **MATHIAS**. In other words, what you are telling the committee is that it is a kind of "mom and pop" scene?

Mr. **TANENBAUM**. Yes. [Laughter.]

The competition in this business will cover a great span, I think, but there are going to be a lot of very, very large players in it, and we think we are going to have our hands full—we know we are—in terms of competing with those organizations.

Senator **MATHIAS**. We thank you very much for being here this morning.

In accordance with my previous request, we do ask you to be available for further questions should they arise from other members of the committee.

Mr. **TRIENENS**. If the Senators would like to address any questions to us, we will be glad to answer them.

Mr. **TANENBAUM**. Yes. And we would also like to have an opportunity—if good reason arises—to submit further information.

Senator **MATHIAS**. The record will be held open for that purpose.

Mr. **TANENBAUM**. Thank you very much.

[The material follows:]

Statement of Morris Tanenbaum
Executive Vice President -- AT&T
July 24, 1981
Summary

Over the last decade there has been a distinct policy shift toward competition -- a high degree of confidence on the part of regulators, government policy-makers and the public that competition in the marketplace would best serve the Nation. Communications common carrier regulation has tried to keep pace, but the Communications Act of 1934 is not adequate to cope with the environment of the 1980's and 1990's.

An authoritative restatement of the policy can open the way to a new era of accomplishment on the part of the telecommunications industry. Although it foreshadows massive and difficult changes for us, we are encouraged by the action which the members of Congress are taking to address this important question.

S.898 represents such a comprehensive revision of the Communications Act. Through reliance on competitive forces, it seeks to maximize the opportunities presented to our society and economy in the "information age". In fashioning a structure within which AT&T and indeed the entire industry could best meet the purposes of S.898, a compromise solution has been reached -- a solution which imposes massive reorganizational burdens on the Bell System. The solution contemplates two separate and distinct technologically integrated entities within the Bell System

History has shown that the provision of telecommunications service is enhanced through what is called the "total systems approach". Within the Bell System this "total systems approach" is embodied in an integrated organization and has produced the best telecommunications service in the world. The telecommunications network and the service it provides is crucial to the Nation's economy, security and defense.

The need for an integrated Bell System structure arises from the very nature of the nationwide telecommunications network. The network is by far the most complex assemblage of electrical and electronic equipment in the world. Because of this complexity and the demands placed upon the network, an unparalleled degree of coordination and compatibility among the network's parts and functions is required.

It is really this nationwide network that has dictated the structure of the Bell System, not the other way around. A number of public interest benefits flow from this integrated structure that includes AT&T, Western Electric, Bell Laboratories, Long Lines, and the 23 Bell Operating Companies. It provides a total systems approach to telephone service and the assurance of compatibility, reliability and quality in the network. Integration also facilitates and speeds innovation, assures that demand is quickly and reliably met, provides substantial cost advantages both to the Bell System and to the public, and supports the national defense and security in time of emergency.

This same structure will be critical in the future if the Bell System is to compete fairly and effectively with the many technologically integrated firms entering the telecommunications market in this country. In short, a technologically integrated Bell System remains unequivocally essential to the best interests of the telecommunications industry and the Nation.

Statement of

Morris Tanenbaum

My name is Morris Tanenbaum. I am Executive Vice President of the American Telephone and Telegraph Company. In my 29 years in the Bell System I have held a number of management positions including Executive Vice President for Systems Engineering and Development at Bell Laboratories, Vice President of Engineering and Vice President of Manufacturing - Transmission Equipment at Western Electric, and President of New Jersey Bell Telephone Company.

The Need For Legislation

Over the last decade or so, in many regulated areas there has been a distinct public policy shift toward competition -- a high degree of confidence on the part of regulators, government policy-makers and the public that competition in the marketplace would best serve the nation. This has occurred in telecommunications as in other fields. Furthermore, in telecommunications, technology has blurred the distinctions which once might have existed between the important areas of computers and communications. As a result, the "Information Age" is upon us.

Communications common carrier regulation has tried to keep pace. Regulators, particularly the Federal regulators, have worked to stimulate and meld rapidly growing competition with a regulatory framework which never contemplated the free exercise of marketplace forces and the enormous technological evolutions of the 1970's.

A regulatory charter based on the experience of the first third of this century simply is not adequate to cope with the environment of the 1980's and 1990's. We -- the American public and American business -- need a contemporary, comprehensive declaration by Congress of the Nation's telecommunications policy for the future.

An authoritative restatement of the policy can open the way to a new era of accomplishment on the part of the telecommunications industry. Ours will be a better, stronger and more productive Nation as a consequence.

At the heart of the question of national telecommunications policy -- a policy which seeks to assure quality basic service, preparedness in times of national emergency, technological advancement, together with deregulation and reliance on competition, where feasible, within a context of full and fair competition -- is the issue of what is the appropriate structure and role for the Bell System.

Although it foreshadows massive and difficult changes for us, we are encouraged by the action which the members of Congress are taking to address this important question. Current litigation also seeks to address this question -- the question of Bell System structure but from a different and narrow perspective. We are in agreement with the former Attorney General of the United States Griffin Bell who stated before the Commerce, Science and Transportation Committee on June 16:

> [Q]uestions of the magnitude posed by the American Telephone & Telegraph litigation should be reviewed by Congress in a broad context. The legislative process is singularly appropriate for situations like this which require a balancing of almost unlimited social, economic, and policy concerns extending beyond the scope of the federal antitrust laws.

The Issues Are Not New

The issues being raised by these hearings have been addressed in a number of forums over the last decade and a half.

In August of 1967, President Johnson appointed a Task Force "to make a comprehensive study of communications policy." The result was a report issued in December 1968 which involved the cooperative effort of fifteen Departments and Agencies of the Federal Government, eight special research contracts, as well as contributions from over 50 representatives of the academic community, firms within the industry and other interested parties.

In its Final Report the Task Force concluded that, "given the nature of public message telephone service, integrated control remains vital." Further, "the broad goal of public policy should be to release and encourage potentialities for innovation in technology and in management, both within the public message telephone network and outside it, where such changes do not affect its basic integrity and viability".

In March of 1973, the late Senator Philip Hart initiated hearings on S. 1167 -- The Industrial Reorganization Act -- before the Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary. That legislation sought "to supplement the antitrust laws and to protect trade and commerce against oligopoly power or "monopoly power" in seven industries. By the time hearings on the bill adjourned in July of 1974, the Committee had accumulated a printed record of over 4,300 pages on the communication industry alone which addressed a wide variety of issues -- Bell System structure, the growth of competition, the industry's response to competition, and allegations of anti-competitive behavior. Although the record of the hearing is highly instructive on the issues, a Committee Report was never issued.

Following three days of hearings in September 1976 on the subject of competition in domestic telecommunications before the Subcommittee on Communications of the House Committee on Interstate and Foreign Commerce, which resulted in a printed record of over 1,300 pages, Representatives Van Deerlin and Frey announced their intention to accomplish a "basement-to-attic" rewrite of the Communications Act.

In March of 1977, the Subcommittee on Communications of the Senate Committee on Commerce, Science and Transportation conducted three days of oversight hearings on domestic telecommunications common carrier policies which resulted in a printed record in excess of 1,370 pages.

In April 1977, the Staff of Mr. Van Deerlin's Subcommittee on Communications in the House published a 664 page volume entitled Options Papers for the purpose of exploring issues relative to a Communications Act rewrite including the structure question. Exhaustive hearings were held on the Options Papers through the summer of 1977. The outgrowth of this effort was the "Communications Act of 1978" (H. R. 13015) the first of the comprehensive attempts to rewrite the Communications Act of 1934.

The first comprehensive rewrites of the Communications Act were introduced in the Senate in March 1979 -- "The Communications Act Amendments of 1979" (S. 611) and "The Telecommunications Competition and Deregulation Act of 1979" (S. 622).

Since the introduction of H. R. 13015 back in 1978, there have been 21 days of hearings involving 467 witnesses with over 9,000 pages of transcript in the House on rewrite issues. Similarly, since March 1979, there have been 11 days of hearings involving 237 witnesses with over 4,500 pages of transcript in the Senate on the rewrite issues.

In a further effort to focus on national communications policy issues, the National Telecommunications and Information Agency under the direction of Henry Geller issued a Primer in November of 1979. The Executive Summary of the Primer stated:

> The 1934 Act is no longer adequate as a statement of national policy. Certain provisions impede the delivery of technologically advanced and lower cost goods and services in the increasingly important sector of the Nation's economy. Congress can and should remedy this situation by making a limited number of straightforward changes in the Act .... If the Congress fails to make these changes, the inevitable consequence will be a continuation of a long series of disruptive regulatory and court challenges which will find telecommunications policy being established by the judiciary system under the inadequate guidance of an outdated statute.
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> Currently the ability of AT&T to provide facilities or services with an information or data processing component is in doubt because of the 1956 Consent Decree. It enjoins AT&T from engaging in any business other than the furnishing of communications common carrier services that are subject to regulation. The Decree was written in an era when telecommunications services and information or data processing services were clearly separate and distinct. These two technologies are continuing to merge and both regulated telecommunications and unregulated data processing vendors desire to offer -- and customers demand -- services which combine the two. Without modification of the Consent Decree, Bell may be precluded from offering such hybrid services and the public is thereby deprived of the benefits of its competition. ... With the exception of mass media information services ... Congress should correct this situation to allow AT&T to engage in unregulated telecommunications and incidental activities with appropriate safeguards (i.e., a fully separated subsidiary).

Thus, these complex and important issues have received extensive, thorough, and prolonged review by each arm of the Government with responsibility and expertise.

Background: S. 898

S. 898 "The Telecommunications Competition and Deregulation Act of 1981" is the current comprehensive revision of the Communications Act of 1934 in the Senate. It offers solutions to the myriad of issues raised by the rapid growth in our Nation's telecommunications needs and the burgeoning technological advances within the information industry. Through reliance on competitive forces, the legislation seeks to maximize the opportunities presented to our society and economy in the "Information Age" and maintain our country's world leadership in this vital industry, while preserving universally available, high quality basic telephone service at reasonable and affordable rates.

In fashioning a structure within which AT&T and indeed the entire industry could best meet the purposes of S. 898, a compromise solution has been reached -- a solution which imposes massive reorganizational burdens on the Bell System. The solution contemplates two separate and distinct technologically integrated entities within the Bell System.

The structure called for in S. 898 is similar to that proposed by the FCC in its decision in the Second Computer Inquiry in that it, too, requires a separate subsidiary for detariffed service offerings. S. 898 goes much farther than the Second Computer Inquiry, however. The bill requires, over a six-year transition period, that manufacturing and research and development in support of products and services to be offered by the separate affiliate be done by that affiliate or procured from others. This separates the fully separate affiliate from the carrier's activities and imposes restrictions on the type of activities the fully separate affiliate can engage in. The bill does not prevent either the carrier or the fully separate affiliate from having a technologically integrated structure. Nor, subject to transactional safeguards such as information disclosure and offering to sell to others, does the bill foreclose the two types of entities from dealing with each other if such dealings make sound business sense. Howard Trienens, Vice President and General Counsel of AT&T, will be addressing the adequacy of the structural separation requirement in S. 898.

A Structure in the Public Interest

In dealing with the structural issue, both in terms of the telecommunications industry and the Bell System, S. 898 represents the culmination of study and debate which ranged from the present industry and Bell System structure on the one hand, to a fractured industry and divested Bell System on the other. Both extremes have been rejected for a variety of reasons in favor of a solution which encourages competition, prevents alleged opportunities for cross-subsidy and controls alleged exercise of market power, while assuring universal telecommunications service at reasonable and affordable rates.

Currently the Justice Department is advocating divestiture. Some -- but not all -- of our competitors recommend it. Of course, the recommendation that the Bell System divest itself of its manufacturing and supply unit, the Western Electric Company, has been advanced before. But each time this relationship has been examined seriously by regulatory or governmental bodies, the existing structure has been preserved.

A technologically and horizontally integrated structure is critical to the Bell System's continued ability to meet, effectively and economically, the Nation's growing communications needs.

History has shown that the provision of telecommunications service is enhanced through what is called the "total systems approach". Within the Bell System this "total systems approach" is embodied in an integrated organization.

AT&T, as the parent organization, provides policy as well as detailed day-to-day guidance in the development of technology and customer services. The General Departments of AT&T assure the Bell System's ability to meet emerging customer needs by bringing together -- in one place -- the service and technological requirements of the Operating Telephone Companies and Long Lines, a detailed knowledge of present technology, and an in-depth understanding of the potential of future technology. All major new technological projects are undertaken under the general guidance of these headquarters groups.

The fundamental mission of Bell Laboratories is to assure that the Bell System will have available the knowledge and technology essential to meeting the Nation's current and future communications needs.

Even though Bell Laboratories is most often thought of as a research organization, research accounts for only about 15 percent of its total effort. The bulk of its activities are devoted to engineering and detailed design. Bell Laboratories' activities are guided by its systems engineers, who match telephone company needs with the opportunities arising out of new technology.

Western Electric is the Bell System's manufacturing and supply unit, and as such is managed in the interest of the service requirements of the Operating Companies and Long Lines. Western Electric frequently is viewed only as a manufacturer. It is important to this discussion, however, to recognize that Western Electric carries out a host of other essential functions for the Operating Telephone Companies and is closely involved with the work of Bell Laboratories as well.

Long Lines is the operating arm of AT&T. It constructs, maintains, and operates the long distance network which interconnects Bell as well as independent telephone companies. In effect, Long Lines serves as a "managing partner" -- coordinating the growth of the interstate network as its facilities and routes are continually reconfigured under an overall technical master plan.

The 23 Bell Operating Telephone Companies concentrate on local and regional service needs. The basic mission of the Operating Telephone Company -- to meet the public's demand for high quality telecommunications service at the lowest possible cost -- is the same mission which sets the goals and dictates the activities of all of the units of the Bell System.

The mission is to serve -- and to fulfill that mission the service process must be a continuous one, extending uninterruptedly from the creation of knowledge, to invention through development, manufacture and supply to customer service.

In light of this mission and the demanding nature of the telecommunications network, the benefits of a technologically integrated structure are clear. The primary benefits of Bell System integration -- to the individual units and, more importantly, to telecommunications users -- are these:

1) It permits a "total systems approach" to telephone service. Planning, research invention, design, development, manufacture and operations are directed toward a single objective.
2) It assures the necessary compatibility, reliability and quality of equipment needed for optimum network function.
3) It facilitates and speeds innovation in the complex, interdependent network.

4) It assures that the demand for telephone equipment and service is met quickly and reliably.

5) It provides substantial cost advantages. In addition to the many other economies the Bell System achieves through integration, Western Electric's prices for telecommunications products average about 16 percent below those of the lowest general trade supplier, thereby providing substantial savings to the Bell Operating Telephone Companies.

The results speak for themselves. This Nation has the largest, most advanced and efficient telecommunications network in the world. Thus, it is clear that the approach we have taken in this country works -- and works well. Can a different approach, a nonintegrated approach, work equally as well? The answer is no. There must be a centralized plan and control of the overall process -- there is really no choice in the matter. The only question is, "What is the optimum way to achieve that control in the public's best interest?"

The factors which have led to the Bell System's structure are not unique to this country. Although the United States network is significantly larger and more advanced than those of other countries, the problems faced by foreign telephone administrations are not basically different from our own.

Other nations have approached the problem in a variety of ways, some closely similar to the Bell System. Sweden and the eastern provinces of Canada are served by organizations with integrated structures very much like the Bell System. And -- not coincidentally -- the service they offer is among the best outside the United States.

The Japanese also are building a first-class telephone system, using a form of de facto integration with suppliers which is characteristic of their cooperative industrial approach.

In Western Europe, the telephone systems purchase their equipment from selected private companies through complex allocation procedures. Anyone who has been to Europe, even quite recently, will know that the quality of telephone service there is noticeably below that of this country -- even though major expenditures have been made for research and development.

Over the years, renowned economists, scientists, regulators and observers of the public utility scene have examined the Bell System structure and the overwhelming weight of opinion is that the Bell System's integrated structure should be retained, that its high level of performance merits emulation elsewhere, and that dismembering the Bell System would be seriously detrimental to the public interest. The opinions of various authorities are set forth in Attachment A.

It is also of interest to note that the electric power industry, which for decades depended on nonintegrated suppliers for its research and innovation, has, with the establishment of EPRI (Electrical Power Research Institute), moved in the direction of a more centrally directed technology. As a not-for-profit cooperative endeavor, EPRI funds and coordinates a $217 million program for the electrical industry. It was established with the strong encouragement of the Congress and the National Association of Regulatory Utilities Commissioners (NARUC).

Paradoxically, while voices both here and abroad have argued in favor of greater integration so as to effectively develop and operate complex systems, others appear to call for fragmenting the integrated structure of the Bell System.

This raises a question as to why -- given the demonstrable advantages to the public of having an affiliated manufacturer in a technologically integrated structure -- voices are heard which would deny the Bell System the ability to utilize such an integrated structure.

Perhaps the rationale rests on the concerns that the present technologically integrated structure of the Bell System may somehow thwart the intention of the bill to increase competition in telecommunications. Possibly those concerns center either on the ability of nonaffiliated manufacturers to sell to the Operating Telephone Companies or on the possible cross-subsidization between Western Electric products which might result in unfair competitive advantages to the Operating Telephone Companies.

First, it has not been our intent -- nor our practice -- to establish Bell Laboratories as the sole source of innovation nor Western Electric as the sole supplier of equipment to the Operating Telephone Companies. Last year, fully one-third of all Bell System expenditures for telecommunications products went to outside manufacturers. The long-standing policy of the

Bell System is to buy the best equipment available from any reliable source. Several years ago, the Bell System's Purchased Products Division was established in AT&T to enhance the execution of that policy. To further support the ability of the Operating Companies to take advantage of general trade products, we proposed to the FCC the formation of a subsidiary which would undertake centralized purchasing of communications products and supplies from the general trade.

Furthermore, it should be understood that Western Electric's accounting systems provide great and accurate detail on the costs of each of its products. These systems are regularly audited and have been examined and confirmed by the regulatory agencies. Thus, this concern should be laid to rest.

However, the most important point is: Western Electric is a manufacturer of communications equipment -- and we think the finest such organization in the world -- but Western Electric is not just a manufacturer. Most importantly, it is a critical link in the entire innovation and service process that has created this Nation's unequaled telecommunications network. The effectiveness of this process depends on close coordination and precise, systematic organization of resources. Separating Western Electric from Bell Laboratories on the one hand and from the Operating Telephone Companies on the other would destroy this process.

It would obstruct innovation by disrupting the close working relationships that link the people who make telephone facilities to the people who design them and the people who operate them. Now, more than ever, research, product and process development, and service are intertwined.

Divestiture of Western Electric would deny the Operating Telephone Companies -- and their customers -- the advantages of an affiliated manufacturer committed not to objectives of its own but to theirs.

Because Western Electric is linked in purpose to its customers, it assumes responsibility for providing products of the exacting quality that good telephone service requires at the lowest cost over the products entire service life. It also continuously addresses itself -- whether it confronts competition or not -- to reducing the cost and improving the performance and reliability of its products.

Because Western Electric shares the responsibility for the performance of the nationwide switched network, it stands ready to provide whatever components of that network the Operating Telephone Companies might require -- a replacement for a piece of apparatus made 40 years ago or the product of the most advanced electronic technology.

Because Western Electric's mission is the Bell System's mission -- that is, service -- the company provides its customers, the Operating Telephone Companies, continuous assurance of delivery of the products they want on a where-wanted, when-wanted basis. Western Electric also stands ready to move immediately and unhesitatingly to help restore telephone service to our customers, whenever and wherever it might be interrupted.

In short, divestiture would remove a critical link from the innovation and service process -- thereby destroying the common purpose and necessary close interaction between the innovator, the implementor, and the operator of the technology upon which our telecommunications system is based.

The Congress should also be aware that divestiture is also likely to result in the massive fragmentation of Bell Laboratories. Western Electric is totally dependent on Bell Laboratories for product design and could not exist as an independent, competitive manufacturer without highly capable design groups, such as those in Bell Laboratories that serve it now.

Not only would such fragmentation further debilitate the Bell System's ability to continue its outstanding performance, it would also effectively destroy the structure in which the Bell Laboratories/Western Electric team has functioned as an important national resource.

Bell Laboratories and Western Electric have, on many occasions, served the Nation's interests in defense preparedness and space exploration. Following World War II, Bell Laboratories and Western Electric were called upon to establish Sandia Laboratories, which managed the Nation's effort in atomic weaponry. The same team has been a major contributor to the Nation's air and under-water defense systems.

During the Apollo manned space program, at the request of NASA, AT&T established its Bellcomm subsidiary using resources of Bell Laboratories and Western Electric in order to provide systems engineering support for the program.

Today, the need for teamwork between Bell Laboratories and Western Electric is actually intensifying as the subtleties of development, design and manufacture have become more closely joined. Good examples of this are the sophisticated design and manufacturing processes used to produce Very Large Scale Integrated (VLSI) circuits -- the tiny silicon chips that are the foundation of today's telecommunications and information-processing systems. With technology rapidly progressing toward chips with perhaps a million components, only technologically integrated companies can know best how to design such devices because they can anticipate the most promising applications for them. The close cooperation of Bell Laboratories and Western Electric has kept the Bell System at the leading edge of the microelectronics revolution.

In addressing the question of divestiture within the context of pending legislation, the Department of Defense pointed out the potentially severe adverse impacts upon national defense and security or emergency preparedness that could result from eliminating any carrier's ability to manufacture equipment through an integrated subsidiary. Further, it was pointed out that "the integration of the functions of basic research, development, design, manufacture and standardization of operation and installation are significant capabilities useful in improving responsiveness in emergency or reconstitution situations and thus are valuable assets to the Nation."*

In light of the Bell Systems's performance record and the repeated recognition over the years of the benefits flowing from its technologically integrated structure, the structure of the Bell System is a matter of national concern. It impacts the infrastructure of our society and has ramifications for prosperity, employment, national defense and this country's position in the world.

The technological and operating structure of the Bell System is essential to this Nation's continuing position as the uncontested world leader in telecommunications. That structure is neither arbitrary nor a relic of earlier, outdated conditions. It is, instead, a living, continuously evolving arrangement of elements that reflects our best efforts to conceive, develop, install and operate an efficient and modern telecommunications network. It is most important to appreciate that this structure is designed to serve the technological imperatives of the network -- not the other way around.

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* Letter from Deanne C. Siemer (signed by Leonard Niederlehner) to the Honorable J. T. McIntyre, dated August 1, 1979.

The Telecommunications Network

The telephone network is the most complex, interactive assemblage of electrical and electronic equipment in the world today.

The network has billions of switches, relays, transistors and integrated circuits, hundreds of millions of miles of wire cable and radio circuits, a myriad of on-line test, measurement and route control devices, and a multitude of different varieties of input and output terminals -- deployed in thousands of cities, towns and rural areas.

Despite this complexity, the faint electrical impulses from a voice falling on a transmitter -- or a pulse of information generated by a computer -- must find their way through this maze of equipment quickly, accurately and reliably, even though the strength of long distance calls may have to be amplified trillions of times. Simultaneously, the network must accommodate the public's diverse needs for a wide variety of other services -- facsimilie, audio, video and data. The network must also be capable of being reconfigured, providing for alternate routes when needed in times of natural disaster or other emergencies. It must have flexibility to handle the increasing demand for service each year. And it must mesh -- compatibly -- the newest generation of technology with those still usefully in place after 10-20 or more years of service life.

Because of its capabilities and the basic human needs it serves, the telecommunications network has become an integral part of the social and economic fabric of our Nation. Its reliable operation is critical to our daily lives. Its continuing evolution -- in terms of service variety, flexibility and quality -- is an important element in the Nation's progress.

Compatibility and Reliability

The complexity of the network and the daily demands placed upon it require a degree of coordination and compatibility among its parts and functions which far exceeds that required by any other industry. Specifically, each particular piece of plant, regardless of its vintage or type -- whether telephone set or data set, wire pair or coaxial cable, switching equipment or carrier system -- must be designed, built and operated to work capatibly. Every part depends upon the quality and technical compatibility of every other part -- all must function in unison and dynamic balance. As the National Academy of Sciences pointed out in its study on interconnection, an incompatible or distorted signal can cause interference with hundreds of other signals, adversely affect service at distant locations, tie up switching machines, cause service outages and wrong numbers, and lead to inaccurate accounting and billing information.*

The level of complexity is so great that frequently the requirements for compatibility cannot be completely anticipated in formal specifications but are the fruit of experience and learning under actual operating conditions. And that experience and learning must be promptly reflected in changes in design or manufacture in order to meet the inexorable discipline of compatibility.

Because of its complexity, size and the critical services the network provides, each of its parts must be reliable to an extraordinary degree. Again, formal specifications of end point requirements are often inadequate, and reliance must be placed on detailed understanding and control of manufacturing processes and materials, and on the rapid response of design and manufacturing engineers to incipient or actual field troubles. In view of this, it is not surprising that Bell System quality assurance procedures have been adopted by designers, manufacturers and purchasers all over the world.

An example of these reliability requirements can be found in telephone switching. The new families of electronic switching equipment are similar in many ways to large computers. However, in view of its critical function in the network, electronic switching equipment is designed to operate trouble-free for all but two hours of its 350,000-hour (40-year) service life, a requirement far more stringent than that of general-purpose commercial computers.

Staff Report No. 5 of President Johnson's Task Force on Communications Policy concluded that the "network's exceptional reliability requirements set it apart". The Bell System and its customers cannot tolerate commercially accepted levels of reliability. That is why it must go beyond formal specifications

* Report of the Panel on Common Carrier/User Interconnections, Computer Science and Engineering Board, National Academy of Sciences, June 1970.

and resort to process and materials control, and why design and manufacturing engineers and network operators must work together closely -- without proprietary organizational barriers -- to assure that the necessary requirements are met in practice.

Presently we have certain performance standards within the Bell System which have been developed over a long period of time. These specify such things as the transmission levels which are appropriate for various connections within the network, the traffic engineering parameters which ought to be used, and the blocking probabilities which should be encountered. People throughout the country can thus expect to get fairly uniform quality of service. In the absence of an overall industry leader, each organization would be free to set these performance standards in such a way as to optimize its own financial performance. Furthermore, such a decision might well impact other interconnecting carriers who would have no control over it.

For example, insufficient provision of local switching or trunking equipment for incoming calls in one area might have substantial effects in another area. Where people who are attempting to make calls find themselves persistenty frustrated due to the inability to complete the call, and thus continue to redial; congestion may develop in the local switches at the originating end. This is costly to the local company which has no way to recover those costs except to burden its own customers. Similarly, if a particular company attempts to set transmission standards which are only marginally adequate to for some connections, then its customers may find it difficult to converse comfortably with certain other areas of the country. Such a situation might cause the blame to be placed on the intercity carrier when, in fact, the local carrier is at fault or vice versa. The customer, in any event, has no way of determining who is at fault or assigning blame.

Technological and Physical Change

Meeting the requirements for compatibility and reliability is essential to obtaining the necessary performance from even a static technology. But the network technology is dynamic. It is subject to a continuously increasing rate of technological change.

Technological change in the telephone network involves at least two critical problems. First, changes must be compatible with what already exists or serious waste and disruption of service may result. The modification or adaptation of existing equipment is often required and must be carefully planned and minimized. Second, changes must be accomplished without adding unnecessarily to the multiple varieties of equipment, which would increase current costs and make future changes more difficult and expensive.

In short, technological change in the network is itself a complex matter. For example, there are now four general types of local switching offices and five major kinds of transmission systems in use, as well as a number of variations of each. And there is currently under active study a major new type of local central office and two new types of transmission systems. Messages in different forms -- such as voice or data -- whether originating from a telephone or data set, must be switched by any existing type of office and then carried by any type of transmission system in the network.

In addition to new technology and new services, the network is constantly subject to still another kind of change -- additions and rearrangements necessitated by the growth and changes in demand for service. Those changes must also be planned in advance and implemented without interrupting or degrading service. Again the requirements for compatibility and reliability are truly staggering, and it is those requirements, as much as any of its other characteristics, that set the telephone network apart and mandate the technological integration of the Bell System.

And what is the focus of technological integration? Its focus is elegant in its simplicity, but intensely complicated in its realization: to optimize technological innovation and to bring the fruits of new technology on line in a timely, orderly fashion in order to meet the diverse telecommunications needs of the Nation at the lowest overall cost to the entire public.

Integration of Exchange and Interexchange Services

The user expects the telecommunications network to provide on demand -- high quality, reliable communications links between desired locations. To the customer originating a call, the boundaries of local and toll service are indistinguishable from the viewpoint of service. The American public simply has insisted that calls be completed, and the carriers worked to make it happen in the most efficient manner possible.

In the Bell Operating Companies, both the connecting lines between switching centers as well as the centers themselves are designed to accommodate calling patterns established by the communities of interest of our customers. As customers' interests change, the network patterns change. Our interoffice trunking patterns are reviewed annually and changed continuously.

The pattern of the network must follow the interests of the people it services. Even when geographical lines are drawn based on state boundaries they must be bridged by planning teams, day-by-day operations arrangements and financial agreements that encourage arm-in-arm teamwork, not arm's-length negotiation.

In addition, the same physical facilities are often used for both interexchange and intraexchange purposes. There are 890 toll switching machines in the United States, 449 of them serve as both local Class 5 offices, capable of completing calls within the local exchange area and as toll switches. Furthermore, intraexchange trunks, interexchange trunks and subscriber loops are frequently found in the same cable sheath.

In addition to the equipment commonalities described above, there are also people who maintain and operate equipment in both spheres, and computer aided operations support systems which are used to maintain and monitor equipment used for both intercity and intracity traffic. Separating such a completely interwoven network, as the Department of Justice suggests, into essentially arbitrary piece-parts would undoubtedly cost billions of dollars, take years to accomplish and cause service degradation of unknown dimensions.

The value of this integration of facilities is clearly demonstrated at the time of natural disaster. Chicago will long remember the "Blizzard of '79." When snow blocked virtually all means of transportation, marooned Chicagoans reached increasingly for their telephones. As local switching equipment reached capacity, local calls were routed to the giant electronic long distance switching system in the city which was able to complete them. The long distance calls normally handled by this equipment were routed through alternate long distance switching centers around the country -- all without adverse effect on the quality of service or added cost to the callers.

On Mother's Day the reverse is true. Switching and trunk capacity is massively rearranged to handle the increased volume of long distance calling.

We use the nationwide network every day in this efficient manner. Although they are perceived by the customer as local services, more and more services such as directory assistance, repair service, and operator-handled calls are administered from points outside of the customer's community.

- Telephone operators often work at switchboard consoles geographically far removed from the customers they serve. And the same operators may handle local emergency calls, calls from the city to suburbs and calls from New Jersey to California.
- Telephone company business offices handle service requests from customers in a number of communities, and repair centers do the same for trouble reports.
- After normal business hours, a single repair center answers calls for repair service for an entire metropolitan area, and similarly, telephone operators at a single center handle long distance and local emergency calls from far-flung points during early morning hours when calling is light. Requirements for fully separated subsidiaries for basic exchange and interexchange services would force us to duplicate much of the presently integrated plant and many of our now centralized operations.

These operations have not developed accidentally. They are deliberate products of technology designed to centralize costly functions in order to assure the most economical and efficient provisions of service to our customers.

Through the years, the nationwide telecommunications network has been planned, developed and administered without regard to municipal or other artificial boundaries, in order to provide universal service at low cost. Our customers have benefitted from that structure. Any attempt to redesign the network along arbitrary exchange/interexchange boundaries would be most costly -- to us and to our customers.

Network Management

There is still another aspect of operational integration that warrants discussion -- the management of the nationwide telecommunications network. Network management works on a national scale, permitting calls to be rapidly rerouted for peak holiday traffic or in cases of emergency and catastrophe. It also works on the state level, for we manage the network in a similar and compatible way. Just as AT&T Long Lines has a national Network Management Center, the local Bell Operating Companies have statewide Network Management Centers that monitor and control traffic for that portion of the network for which they are directly responsible. The Long Lines and local company centers are tied together and can communicate automatically through the manual intervention of their managers. This compatibility of equipment, procedures and training of the operations people is essential to efficient use of the network, especially in times of crisis when arm-in-arm teamwork is particularly critical and local areas or even large parts of the Nation become critically dependent on communications.

About the Future

The introduction of electronic switching, which began in 1965, heralded a new era in the evolution of the network. Electronic Switching Systems (ESS) are controlled by a "stored program." This is a computer program stored in the electronic memory of a powerful and highly specialized computer that controls the operation of high-speed switching mechanisms. The stored program greatly increases the power of the switching system, enabling it to perform a wide variety of functions and permitting those functions to be changed as technology makes new functions possible. For this reason, electronic switching systems are sometimes referred to as "intelligent" systems because they can be "taught" to perform new tasks.

Today there are over 2,000 electronic switching systems in the network, each representing an investment ranging up to several million dollars each. New systems are being added at a rate of more than one per day; electronic "intelligence" is rapidly spreading through the network.

Recently we began to add an important new capability to the network called Common Channel Interoffice Signaling (CCIS). CCIS is a high-speed data network interconnecting the electronic "brains" of electronic switching systems, enabling them to pass information rapidly among switching systems all over the Nation.

This is creating a new capability which we call the Stored Program Controlled Network. It will allow the network to evolve from a large number of independent "intelligent" switching systems to an "intelligent" network -- nationwide in scope and totally integrated. This will greatly increase the efficiency of the network, permitting the completion of transcontinental long-distance calls five to ten times more rapidly than is possible today and at a lower total cost.

At the same time, the "intelligent" Stored Program Controlled Network will place even greater requirements for compatibility on each part of the network. For example, complicated data messages will be sent at high speeds between switching centers which will have to interpret them and take immediate action -- without error. Thus, the requirement for integrated innovation, planning, implementation and operation will be even greater in the future than it has been in the past. Again, the ability of the Bell System to provide this Nation with the world's first Stored Program Controlled Network is a direct result of the technological integration of the Bell System. Furthermore, the technologically integrated structure of the Bell System is particularly well geared to the advancement of technological innovation.

National Defense and Security and Emergency Preparedness

This Nation's telecommunications industry, which is far superior to that in any other country of the world, has been subjected to continuous turmoil throughout the last decade. Far-reaching regulatory actions by the Federal Communications Commission, culminating in its recent Second Computer Inquiry Decision, have sought to reshape and restructure this industry. In 1974, moreover, the Department of Justice initiated an antitrust suit against the American Telephone and Telegraph Company which seeks the divestiture of all the local operations of the Bell Operating Telephone Companies from AT&T, Western Electric and Bell Laboratories and from each other. The Justice Department thus has its own plan for reshaping and restructuring the telecommunications industry, a plan which has not been shared by the Departments of the Executive branch.

The Congress has recognized that these extensive regulatory and judicial actions, based upon a regulatory statute established in a different technological era (i.e., the 1934 Communications Act) and an antitrust statute enacted in another century (i.e., the 1890 Sherman Act) are not adequate to cope with telecommunications in the present and future. In the last four years, therefore, Congress has sought to enact legislation reforming the laws governing this Nation's telecommunications industry to establish the appropriate future structure, goals, and guidelines for that industry. Throughout those four years, the Department of Defense has consistently advised the Congress of the significant adverse impact a breakup of the Bell System would have upon national defense and security and emergency preparedness telecommunications needs.

While Congress has been pursuing telecommunications regulatory reform and seeking to determine the appropriate future structure of the telecommunications industry, the Justice Department has nevertheless continued seeking to impose its views of the proper future telecommunications industry structure through the AT&T antitrust suit. That forum cannot, however, fully or adequately address national defense and security or emergency preparedness concerns. Justice Department representatives have met with DOD officials who offered to provide an analysis of the adverse impact of divestiture scenarios suggested by the Justice Department.

The Defense Department has completed that analysis. From the twofold perspective of DOD's national defense and security telecommunications responsibilities and the broader emergency preparedness telecommunications responsibilities of the Secretary of Defense as Executive Agent for the National Communications System, DOD suggests that divestiture, as currently proposed by Justice (i.e., separation of local exchange from intercity functions) would cause substantial harm to national defense and security and emergency preparedness telecommunications capability.

Bell System Responsiveness to Emergency

Beyond the significant concerns of the DoD with requirements for national security and defense, the Bell System structure is crucial to the Nation's ability to cope with other emergencies and catastrophies.

Three examples of Bell System responsiveness to emergency situations serve to illustrate its effectiveness and efficiency. These examples clearly amplify the ability of a technologically and horizontally integrated structure to serve the Nation's telecommunications needs.

The New York Fire

In February 1975, a major telephone company switching center in New York City was put out of service by fire.

Joined by massive assistance from Western Electric, Bell Laboratories, AT&T Long Lines and other Operating Telephone Companies, New York Telephone was able to place facilities back in service in just three weeks.

Three Mile Island

Averting a catastrophe at the Three Mile Island nuclear plant took the efforts of many individuals, agencies and organizations -- including the telephone industry.

The Bell System and several independent telephone companies worked around the clock to meet the needs of Federal and state agencies, private industry and the news media during the crisis. All requests for services were fulfilled. In many instances, jobs that normally would take days or weeks were completed in a matter of hours. Bell System efforts during the emergency were later praised by government and media agencies.

At the same time, the Bell System and its independent partners kept the nationwide telephone network working smoothly, despite the fact that record numbers of calls, nearly double the normal volume, were pouring into and out of the Harrisburg area.

Southwest Tornadoes

In April 1979, less than two weeks after the Bell System's emergency preparedness plans had been given a crucial test at the Three Mile Island nuclear reactor site in Pennsylvania, tornadoes struck the Southwest and left in their wake power outages, fallen telephone lines and damaged facilities.

AT&T Long Lines, Southwestern Bell and Western Electric combined resources to provide coordinated maintenance and restoration efforts.

Background information on each of these events is provided in Attachment B.

Conclusion

There are compelling technological, economic, and service imperatives to technological integration in telecommunications and well-documented benefits to our customers. Technological integration has enabled the Bell System to build the best telecommunications network in the world.

This same structure will be critical in the future if the Bell System is to compete fairly and effectively with the many technologically integrated firms entering the telecommunications market in this country. Large, technologically integrated Japanese, Canadian and Western European companies have targeted the U.S. telecommunications and information processing markets for concerted attack. Integrated enterprises in the U.S. are largely responsible for the leadership the U.S. currently enjoys in the technologies of the information age. This leadership will be seriously jeopardized or completely lost if, as some have advocated, our most productive technologically integrated enterprises are structurally dismantled. In short, a technologically integrated Bell System remains unequivocally essential to the best interests of the telecommunications industry and the Nation.

In conclusion, I would like to reemphasize that there is a continuing need for an authoritative restatement of the Nation's telecommunications policy. We are heartened with the action taken by the Senate Commerce, Science and Transportation Committee in reporting out S. 898 by a vote of 16-1.

As this important legislation continues to move through the Senate, we appreciate the opportunity the Committee has afforded us to help you focus on the issues being addressed today.

ATTACHMENT A

WHAT OTHERS HAVE SAID ABOUT THE BELL SYSTEM'S INTEGRATED STRUCTURE AND PERFORMANCE

Dr. Otto Eckstein, Professor of Economics, Harvard University and former member of President Johnson's Council of Economic Advisers, in filed testimony in FCC Docket 19129, (Bell Ex. 45) (1974)(p. 45)

> ". . . the present method of procuring equipment of the Bell System through the Western Electric relationship has performed well compared to the other known systems that can be studied. There is no way of telling with certainty whether the present arrangement was necessary to Western Electric's superior performance relative to its industry and other sectors of the economy or whether the ingenuity of man could not devise an equally effective or perhaps even better system. But, based on the performance record, the present Bell-Western arrangement looks pretty good compared to the alternatives."

Eugene V. Rostow, Sterling Professor, Law and Public Affairs, Yale University, in testimony before the Subcommittee on Antitrust and Monopoly of the Senate Committee on the Judiciary (July 30, 1974) (pp. 45-46)

> "Rather, we found it [the structure of AT&T] to be a reasonable and indeed an inevitable system for organizing the kind of inputs which are indispensable to the process of maintaining and improving an integrated national and international system of communications -- research inputs; engineering inputs; manufacturing inputs; and the inputs of overall management. The pattern which the Bell System has developed for the conduct of that process strikes me as an efficient and effective way to bring all these perspectives to bear on an infinitely complex problem. I see no reason to subject that organism to radical surgery.
>
> On the contrary, on this basic and ultimate issue raised by the application of the Hart Bill to the Bell System -- the value to our economy of maintaining the integrated communications network as a viable entity, and allowing Western Electric, the Bell Laboratories, and the Bell System operating companies to work together in developing, maintaining, and improving it -- it seems to me that a reorganization of the communication equipment industry along the lines prescribed by the Bill would be a disaster -- and a disaster without compensating advantages."

Alfred E. Kahn, Chairman of the CAB, distinguished economist and former Chairman of the N.Y. Public Service Commission, in The Economics of Regulation: Principles and Institutions, Vol. 2 (1971) (p. 305)

> "the essence of the case for competition is that the potential performance of an industry is unknowable; it is the rivalry of independent suppliers that offers the greatest possible assurance that all economically feasible avenues for cost reduction and service innovation will in fact be explored and their results subjected to the impartial test of the marketplace.

> This is not, however, a sufficient guide to public policy in all times and places, as the institution of regulated public utility monopoly itself indicates. It remains possible that the manufacture of equipment for the central core of the natural monopoly, the communications network, is a "natural" part of that monopoly. This writer would find it extremely difficult himself, in the face of the objective record of good performance and the qualitative arguments that provide at least a highly plausible basis for attributing those results in important measure to vertical integration, to recommend the plunge into the unknown."

Howard W. Johnson, Chairman of the Corporation, Massachusetts Institute of Technology, in testimony before the Subcommittee on Antitrust and Monopoly of the Senate Committee on the Judiciary (July 31, 1974) (p. 7)

> "I concluded on the basis of these input and output measurements that there were decided system advantages to the operation of the Bell System and its three component structures as it stands. It is performing exceedingly well.
>
> The question remains would it perform as well with either or both of the laboratories or Western Electric divested. We cannot know the answer for certain. There are no models outside the country that provide guidance in the affirmative. All indications are that the present system performs exceedingly well at the level of the relationship I have described. I conclude that it would be risky in the public interest to experiment with divestment. Once broken, the system would not be easily rejoined."

Robert R. Nathan, President of Robert R. Nathan Assoc., Inc., Consulting Economists, in testimony before the Subcommittee on Antitrust and Monopoly of the Senate Committee on the Judiciary (June 20, 1974) (pp. 13-14)

> "For an economist, it would be possible, if we were starting from scratch, to construct a hypothetical alternative scenario which would be structurally, functionally, operationally, and economically different from what has evolved, with different relationships between research and development, manufacture, installation, and operations, and different relationships between costs and prices. Whether it would better serve the interests of the nation is problematical. But the point is that we are not starting from scratch. We are starting with the world's best telephone system, and it is in no one's interest -- least of all in the public interest -- to take it apart functionally or organizationally and risk impair-

ing its usefulness in the doctrinaire search for unprovable improvements."

Robert A. Solo, Professor of Economics, Michigan State University, in The Political Authority and the Market System (1974) (pp. 352-353)

"On the face of it, compared to other telephone companies elsewhere or to other industries, its long-run performance, in terms of quality, diversity, and the prices of its services has been quite outstanding; and its contributions to world science and technology, through AT&T Bell Laboratories, has been extraordinary."

* * *

"Minuses for size in the dogma of antibigness will not do as a substitute for the systematic evaluation of performance. Nor, as we have seen, is there any reason to rely on a policy of fragmentation to promote creativity and technological advance or to upgrade efficiency or to produce a more equitable distribution of income."

Harvey Brooks, former Dean of Engineering, now Benjamin Pierce Professor of Technology and Public Policy, Harvard University, in "Science Policy in the 70's," Daedalus, Vol. 102, (Spring, 1973) (p. 137)

"The Bell System represents the best example of a highly integrated technical structure in a high technology industry and is widely regarded as the most successful and innovative technical organization in the world."

Harvey Brooks, "The Physical Sciences: Bellwether of Science Policy," Science and the Evolution of Public Policy, (1973) (p. 114)

"On the industrial side, we face growing problems with environmental protection. These may require drastic modification of such older technologies as paper making, mining, electric-power generation, and the internal combustion engine. Many of these problems are long-range, and perhaps are beyond the financial capacity or the time horizons of private industry. Their solution may require new forms of governmental intervention, such as taxing the cash flow of major industries to finance environmental or safety research in a centralized way, either directly, through government, or by new types of regulated monopolies analogous to the Bell Laboratories."

C. H. Townes, Professor of Physics, University of California at Berkeley, "Differentiation and Competition Between University and Other Research Laboratories in the United States," Daedalus, Vol. 102, (Spring, 1973) (p. 155)

"In the long run, however, the value of research to industry or to the economy as a whole is often overwhelming, especially in industries where techniques and technology can change rapidly. Consider long-distance telephone communications. Between 1935 and 1965, the cost of a long-distance telephone call across the North American continent decreased by a factor of about four in actual dollars. In view of inflation, this was a reduction in real cost by a factor of about twelve, and since 1965 direct dial costs have decreased still further. While some of this cost reduction surely resulted from increased use of the telephone, much of it derived from research and development, some of it quite basic. A very large fraction of the applicable research and development took place in the Bell Telephone Laboratories, the dominant communications laboratory in the United States, a fact which enables one to specify its character and cost with some surety. The yearly bill in 1965 for all long-distance telephone calls in the United States was about $4 billion. With the knowledge and technology available in the mid-30's, the same service would probably have cost $25 billion dollars or more. For such service, present technology thus saves the American public many billions of dollars each year. The regulation of rates for the telephone system has also meant that steady reduction in cost of service provided one of the new routes for the company to increase its profits. How much did this research and development cost? The entire telephone system support of the Bell Telephone Laboratories from its beginning in the 1920's until 1965 was somewhat less than $2 billion. Thus, the decrease in cost of services each year is much larger than the total monetary support of the Laboratories over their entire history, and these contributions to long-distance telephony are, of course, only a part of the Laboratories' work."

Dr. Philip H. Abelson, President, Carnegie Institute and Editor of Science, at International Meeting on the Organization of Science (1973)

"The Bell Laboratories is a principal research facility of the American Telephone and Telegraph Company. A large number of great basic discoveries has been made there. As an example, solid state physics largely originated there. In the Bell Laboratories scientists and engineers interact very well, scientific discoveries are coverted into products, and engineering problems stimulate work leading to discoveries."

Frederic M. Scherer, Professor of Economics, Northwestern University, in Industrial Market Structure and Economic Performance (1970) (p. 468)

". . . the plan for breaking off Bell Telephone Laboratories from Western Electric, putting what Fortune called 'the world's greatest industrial laboratory under the wing of A.T.&T., reflected a completely inadequate understanding of industrial research and innovation."

C. Lester Hogan, Vice Chairman (Board) and Director, Fairchild Camera and Instrument Corporation, in "Integrated Circuits and the Electronics Industry," presented at American Physical Society -- American Association of Physics Teachers (January 29, 1973) (p. 18)

"Bell has led in the development and use of an incredibly complex infinity of technical developments. It has planned, organized, built, and managed the most extensive and complex electronics system in the world, and has offered to this country the best information handling and communications systems that exist . . . ."

John E. Tilton, Associate Professor of Mineral Economics, Pennsylvania State University, International Diffusion of Technology: The Case of Semiconductors. Washington: The Brookings Institution, (1971)

". . . (Tables showing major product innovations) indicate the dominance of American firms during the postwar period in introducing the major semiconductor innovations. Among the American companies, Western Electric, building on the research of Bell Laboratories, has been the leader, although in recent years the share of other American companies has been growing." (p. 18)

> ". . . Thus, the data on patents, major innovations, and R&D expenditures indicate that AT&T (including Bell Laboratories and Western Electric) has contributed more to the innovative process and semiconductor technology than any other firm. The number of its patents and of its major innovations greatly exceeds the number of each attributed to other firms, and the amount it spends on R&D in the semiconductor field represents a sizable part of all such expenditures." (p. 63)

Joseph C. Swidler, former Chairman of the Federal Power Commission and of the New York Public Service Commission in Appendix B to the Report of the Ad Hoc Committee of the NARUC on Energy Research and Development (p. 687)

> "The great potential advantage of the industry approach is the opportunity for close integration between R&D and the practical operation of the nation's power systems, with the industry managers contributing a flow of problems and research suggestions, the research and development arm responding . . . and receiving a feedback of operating results. While I do not hold out the Bell arrangements as a model for the power industry, I am impressed that the responsiveness of Bell Telephone Laboratories to the research needs of the Bell operating companies finds no parallel in the power industry. In its own way the electric power industry should be seeking an intimate and closely articulated relationship between the research and operating institutions of the industry."

Jervis Langdon, Jr., President & Chief Exec. Officer, Penn Central-Transportation Co., The New York Times, (April 1, 1973) Section 3 (p. 14)

> "Perhaps the time has come for private ownership seriously to consider an organizational structure to preside over the different operating units in the present national railroad system. Possibly, this could be along the lines of the American Telephone and Telegraph Company, or a holding company pattern.
>
> Certainly a central control would bring order out of the present confusion; give a sense of direction to the individual railroad, and bring them together in providing better transportation service for the entire country. It should also stop the interminable quarreling and eliminate the staggering expense that inevitably arises when railroads are forced to deal with each other.
>
> More importantly, central control (in whatever form attainable) would give the country the

> great advantages of a rail system that operated as a true system. The public would have the use of the most efficient routes without regard to interchange points and car supply would be geared to national needs and not be limited by the financial ability of the individual carriers to make their contributions to the so-called national freight-car pool."

Touche Ross & Co., Final Report to the Federal Communications Commission on the Comprehensive Review of the Western Electric Company (January 31, 1974) (ALJ Ex. 1)

> "Western Electric, overall, is an efficient organization and makes good use of manpower, systems, equipment and corporate relationships in terms of producing goods and providing services according to specification, in sufficient quantity, at the time required, at minimum cost, given that the goods and services ordered by the operating companies were, in fact, required.
>
> Western Electric's efficient performance has resulted in lower costs than otherwise would have been incurred. Because of Western's pricing policies and practices, these lower costs have not increased profits, but have been passed on to operating companies in the form of lower prices." (p. 3)
>
> "The effect of the interrelationship between Bell and Western Electric is to operate Western, not as a manufacturing concern, but as an integral part of a vertically integrated communications firm. These interrelationships result in a favorable impact upon Western's costs, prices, and service to operating companies." (p. 5)
>
> "The interrelationships between Bell, Western and Bell Laboratories have generally reduced costs and investment." (p. 6)
>
> "There is no evidence that the interrelationships were used, or that the decision-making process was manipulated either to retard successful commercial introduction or to prematurely accelerate commercial application." (p. 7)
>
> "Western Electric employs a full absorption cost accounting system. Its cost accounting practices are reasonable and consistently applied. Generally, the system provides the information required by management to control operations and to apply their pricing policies." (p. 9)

> ". . . Analysis of this market structure indicates that Western Electric cannot be separated in any meaningful sense from the rest of the Bell System. It is unique as a manufacturer because of its ties to the Bell System and, in an economic sense, it functions as just another part of an enterprise devoted to the production of communications services." (p. 9)

National Export Expansion Council, Report of the Industry Advisory Committee on Telecommunications (1973)

> "In the United States, the telephone and telegraph and long-haul communications industries have essentially originated from one source -- the Bell System (including Western Electric, Teletype Corp. and the Bell Telephone Laboratories). The growth has been characterized by good systems design, excellent products, and innovative thinking directed toward continually improving the quality-availability to cost ratio in services rendered." (p. 39)
>
> Domestically, the communications industries have grown essentially through the Bell System, including Western Electric, Bell Telephone and Bell Labs. The product lines evolved out of this base have been highly reliable, very advanced, and extremely low cost in terms of services rendered and product line support." (p. 95)

British Select Parliamentary Committee on Nationalised Industries, "The Post Office" Vol. I, Report and Proceedings of the Committee, Discussing the British Telephone System (1967) (p. 168)

> ". . . regard should be paid to the benefits to be derived from a substantial manufacturing unit under the Post Office's control giving a quick, direct and full feedback to the Post Office's research and development organization of relevant information regarding technical difficulties encountered in the course of manufacture. Such feedback might be expected to be more effective than that which can be obtained, under present arrangements from the private manufacturer. Similar benefits might be gained by closer association of manufacturing and operating responsibilities, both from interchange of technical experience and from being able to relate, as closely as possible, supply to fluctuations in demand. In these ways the Post Office could derive similar advantages to

those derived by the Bell System from having research, manufacture and operations under a single control."

President's Task Force on Communications Policy, Staff Paper 5 (1969) (p. 193)

> "The costs and benefits of vertical integration in telecommunications are not easily quantified. On the side of dissolution is our interest in enlisting the resources of the aerospace, computer, and electronics manufacturers alongside Bell Laboratories, so as to increase diversity of approach in communications research and development. On the other side are the delays and cost-control problems associated with contractural procurement. These costs increase as the system being developed grows larger, more complex, and more highly interactive. Therefore, the case for a carrier-manufacturer tie is at its strongest in telecommunications."

ATTACHMENT B

Included are detailed reports of Bell System Responsiveness to Emergency situations.

1. Destruction by fire of New York Telephone Company switching center, February 27, 1975.

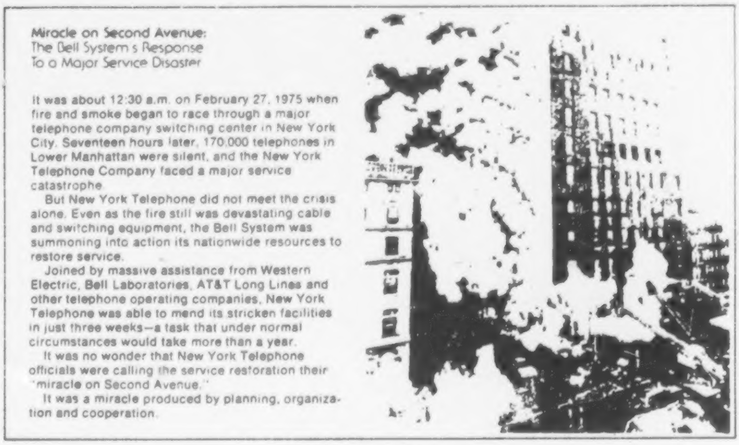
2. Provision of emergency communications facilities, Three Mile Island nuclear facility.

   Commendation letter - Joseph M. Hendrie, Chairman, United States Nuclear Regulatory Commission, July 3, 1979.

3. Maintenance and restoration of telephone facilities destroyed by tornado, April 3, 1979.

ATTACHMENT B1

BELL SYSTEM RESPONSIVENESS TO EMERGENCY



Miracle on Second Avenue:
The Bell System's Response
To a Major Service Disaster

It was about 12:30 a.m. on February 27, 1975 when fire and smoke began to race through a major telephone company switching center in New York City. Seventeen hours later, 170,000 telephones in Lower Manhattan were silent, and the New York Telephone Company faced a major service catastrophe.

But New York Telephone did not meet the crisis alone. Even as the fire still was devastating cable and switching equipment, the Bell System was summoning into action its nationwide resources to restore service.

Joined by massive assistance from Western Electric, Bell Laboratories, AT&T Long Lines and other telephone operating companies, New York Telephone was able to mend its stricken facilities in just three weeks—a task that under normal circumstances would take more than a year.

It was no wonder that New York Telephone officials were calling the service restoration their "miracle on Second Avenue."

It was a miracle produced by planning, organization and cooperation.

ATTACHMENT B2

Three Mile Island: The Telephone Industry's Role

Averting a catastrophe at the Three Mile Island nuclear plant took the efforts of many individuals, agencies and organizations -- including the telephone industry. Communications quickly became the life blood of the incredibly complex task of assessing the situation and devising solutions.

The Bell System and several Independent telephone companies worked around the clock to meet the needs of federal and state agencies, private industry and the news media during the crisis. All requests for services were fulfilled. In many instances, jobs that normally would take days or weeks were completed in a matter of hours. Bell System efforts during the emergency were later praised by government and media agencies.

At the same time, the Bell System and its Independent partners kept the nationwide telephone network working smoothly, despite the fact that record numbers of calls, nearly double the normal volume, were pouring into and out of the Harrisburg area.

During the emergency, more than 400 special facilities and services were installed at more than 50 separate locations -- including the crippled reactor plant -- in Pennsylvania, Washington, D.C. and Maryland. The services and facilities were used by four federal agencies and departments, eight Pennsylvania agencies and by more than 30 different news organizations from around the country and the world. In addition 250 network circuits were added to the Harrisburg switching complex.

Most of the facilities were installed at the "trailer city" that was established on vacant land at the Metropolitan Edison Company's observation center across the Susquehanna River from Three Mile Island, at the Middletown Borough Hall and at a vacant hangar at Harrisburg International Airport.

The boundary line between Bell of Pennsylvania and United Telephone Company of Pennsylvania areas ran through the observation site, and the two companies worked together to install, rearrange and maintain emergency services.

Bell of Pennsylvania completed installation of a large communications cable to the site and a telephone switchboard 30 hours after Metropolitan Edison made the request. In addition, the company installed emergency communications facilities at the airport and eventually in the crippled plant itself once work crews were allowed in.

The Bell System's first involvement with the situation occurred on March 28, two days before Pennsylvania Governor Dick Thornburgh announced he was considering evacuating the four-county area surrounding the plant.

At 10:10 a.m. on March 28, the American Telephone and Telegraph Company's Long Lines Department office in Washington was alerted by the Nuclear Regulatory Commission of the "possible need" for special communications service because of "an incident" in Pennsylvania.

At 10:30 a.m., AT&T Long Lines notified the Department of Energy's Nuclear Emergency Search Team (NEST) that the Bell System was prepared to provide whatever services were necessary.

Later on the same day, Bell of Pennsylvania established the first three-way conference call linking the reactor site with NRC headquarters in Bethesda, Md. and its regional office in King of Prussia, Pa. The company also installed special lines for the federal Department of Energy at the observation site.

As the threat of a meltdown became known on Friday the call volumes into the Harrisburg area increased markedly to nearly double the normal load. Calls from all over the country were restricted so emergency calls into and out of the Harrisburg area could be completed. In addition to restricting the calls, approximately 250 circuits were added to the Harrisburg network to help carry the added load.

At 11:25 a.m. on Friday, March 30, about 1 1/2 hours after Governor Thornburgh's announcement of a possible evacuation, AT&T Long Lines received a request from the White House for three special services.

The first was a "hotline" to Governor Thornburgh's office, which was operating by 2:30 p.m. The second and third lines were to the NRC's mobile command post trailer at the site. The first line to the trailer was operating at 4:53 p.m., the second at 7:50 p.m. Normally, installation of the three lines would have taken two weeks.

As the threat of a meltdown inside the reactor grew on Friday, the NRC again requested a conference call between its headquarters in Bethesda, Md., its King of Prussia office and the reactor site. That connection, which was critical in the early stages of the crisis, remained up for six days.

Also on Friday, additional communications lines and telephones were installed for the Department of Energy and the NRC.

At the same time, national and foreign news media representatives were converging on the scene. At the height of the crisis, nearly 120 special services at more than 30 locations in the area were established for the media alone.

On Saturday and Sunday the heavy calling load in the Harrisburg area was handled by re-routing traffic through different parts of the network.

On Sunday, Bell of Pennsylvania provided the communications facilities for President Carter's visit to the site on only two hours notice. (Brigadier General Josiah Blasingame, Jr., of the White House Communications Agency later praised the effort in a letter to Bell of Pennsylvania President William L. Mobraaten.)

During the next few days, AT&T Long Lines, Bell of Pennsylvania, the Chesapeake and Potomac Telephone Companies of Washington and Maryland and three Independent companies (United Telephone Company, General Telephone Company of Pennsylvania and Continental Telephone Company of Pennsylvania) continued to work together providing additional services to:

The NRC, the White House, the Defense Communications Agency, the Department of Energy and the Environmental Protection Agency.

Also, several Pennsylvania agencies, including: Emergency Management Agency (Civil Defense), State Police, General Services Administration, Department of Energy, Department of Health and Department of Environmental Resources.

Bell of Pennsylvania also coordinated linking the state Civil Defense offices in Daulphin, Cumberland, York, Lancaster and Lebanon Counties into a special network for instant communications.

And contingency communications plans were also prepared in the event of a meltdown, which would have resulted in the mass evacuation of the area. In that event, communicaton facilities for virtually all of the agencies involved would have been relocated to another preselected site.

UNITED STATES
NUCLEAR REGULATORY COMMISSION
WASHINGTON, D.C. 20555

OFFICE OF THE
CHAIRMAN

July 3, 1979

Mr. Robert E. Gradle
Vice President of Government
Communications
American Telephone and
Telegraph Company
2055 L Street, N.W.
Washington, D. C. 20036

Dear Mr. Gradle:

My fellow Commissioners join me in expressing deep appreciation to the employees of AT&T Long Lines, Bell of Pennsylvania, and the Chesapeake and Potomac Telephone Companies of Washington and Maryland, who performed in an exemplary manner to provide emergency communications, under very trying conditions during the Three Mile Island incident.

The U.S. Nuclear Regulatory Commission is extremely grateful for the invaluable support rendered by each of these employees. They are to be commended for the technical competence and responsiveness demonstrated during this period.

Sincerely,

Joseph M. Hendrie
Chairman

ATTACHMENT B3

SOUTHWEST TORNADOES: THE TELEPHONE INDUSTRY'S ROLE

The tornadoes that struck the Southwest on April 10 required extensive efforts by the Bell System and Independent telephone companies to maintain and restore telephone service in the face of widespread power outages, fallen telephone lines and damaged facilities.

AT&T Long Lines, Southwestern Bell and Western Electric coordinated maintenance and restoration efforts after the twisters hit. The worst damage was in Wichita Falls, Tex. and Lawton, Okla.

The situation marked the second time in less than two weeks the units of the Bell System and Independents worked together to provide emergency communications. Starting March 28, when a nuclear accident occured at the Three Mile Island reactor in Pennsylvania, AT&T Long Lines, the Bell Telephone Company of Pennsylvania and Independents worked to provide communications for federal and state agencies, private industry and the news media.

The incoming calling volumes for both Wichita Falls and Lawton were heavy. Nationwide controls were required to lessen pressure on the nationwide network so emergency calls into and out of the area could be completed. It was the same type of "focused overload" situation that occured at Three Mile Island, with calls involving concern for families and businesses focusing on one area.

Some 400 new circuits for Wichita Falls were put in service within two days after an aerial cable was downed. This was accomplished by advancing the scheduled completion of a 4ESS switching system in Fort Worth and a new microwave radio route between there and Wichita Falls.

Calls into and out of the area more than doubled, bringing the daily total to nearly three million.

Heavy calling to Wichita Falls continued through Friday (April 13). Southwestern Bell urged callers to wait until the late night or early morning hours, when calls had the best chance of getting through.

Lawton, Okla. facilities became congested between 9:00 a.m. and 10:00 a.m. on April 11 when the hourly volume of calls in and out of the area climbed from the usual 112,000 to 142,657.

Some 25,000 of these hourly calling attempts were focused on Lawton requiring controls to ensure that outgoing lines would be left free for important calls dealing with the emergency.

Southwestern Bell reported 7,500 phones out of 84,200 in Wichita Falls were knocked out when the tornado struck, and over 1,000 were put out of service in Lawton.

In Wichita Falls, 315 telephone poles and 4,500 phone lines were blown down. On the night of April 10, the city was without utilities with the exception of telephone service. The three Southwestern Bell central offices operated on emergency power generators throughout the night.

About 70 telephone poles were down in Lawton, and full service was not restored until Saturday (April 14).

Southwestern Bell crews worked day and night to restore service. They were aided in their efforts by Western Electric people who were bringing in supplies from the Dallas Works.

* * *

SUMMARY OF STATEMENT OF HOWARD J. TRIENENS (AT&T)

Congress appears to have reached a consensus on a new national telecommunications policy. The major forces driving the formulation of this new policy are the technological progress which has brought us the birth of the Information Age and the desire to substitute market forces for regulation where competition is feasible. The Communications Act of 1934, and the DOJ-AT&T Consent Decree of 1956 are no longer responsive to the current technology and consumer needs -- they are relics of another era. The nation and its telecommunications industry urgently need policy guidelines from Congress more appropriate for today and tomorrow.

Telecommunications is one of the few remaining major industries in which this country has maintained world leadership. AT&T and its affiliated Bell companies have been the principal contributors to this U.S. leadership through increased productivity, achieved largely as a result of technological innovation and an integrated organizational structure that efficiently brings the benefits of that innovation to the public. The Bell System has been and is the leading force in technological development in the world. Continued American leadership in this vital arena depends on the establishment of new policy which would remove the tension between new technology and the existing obsolete laws.

The 1956 Consent Decree put a fence around the Bell System generally limiting it to provision of common carrier telecommunications services. Unless properly construed, the Decree will exclude the Bell System from participation in any market that is deregulated, even the provision of telephone sets. Such an exclusion itself would be anticompetitive. The FCC has recently construed the Decree to permit Bell System participation in detariffed markets, but much controversy surrounds that decision. It would be wasteful to leave this major communications policy issue to the vagaries and delays of extensive litigation.

The structural reform embraced in S. 898 is the result of detailed analysis by many Senate and House Committees, the NTIA, the FCC, and independent consultants. The structural changes mandated for the Bell System are designed to protect against any potential for anticompetitive cross-subsidies by separating regulated basic activities from unregulated competitive activities -- including product development and manufacture. It requires a massive corporate restructuring through the creation of a fully separated subsidiary, and prescribes specific new standards of behavior for that subsidiary -- particularly in relationships with other entities of the Bell System. Competitors are protected by extensive limitations on AT&T (see Appendix to Statement) -- some that go well beyond the minimum necessary to protect the marketplace.

The Department of Justice suit seeks total horizontal and vertical divestiture of the Bell System, which would destroy the integrated network with serious adverse impacts on telephone service in the U.S. Virtually all the charges relate to activities which have been resolved before regulatory agencies since the suit was filed in 1974. AT&T believes there is no basis for the divestiture or restructuring sought. The question of changes in the stucture of an industry as vital to the economy as telecommunications is properly a matter for Congress.

In responding to the areas of concern to this Committee, we recognize an overriding and urgent need to establish a national telecommunications policy. Only Congress can provide the ground rules for the crucial years ahead, swiftly and with unquestioned authority. Absent legislation there will be continuing uncertainty and delay. Foreign competition is not under a similar disability. To permit this situation to continue would be a great disservice to the nation.

- - - -

Statement of
HOWARD J. TRIENENS

My name is Howard J. Trienens. I am Vice President and General Counsel of the American Telephone and Telegraph Company.

I welcome the opportunity to appear before this distinguished committee as I did in 1974 when the late Senator Hart was conducting hearings on competition in the telecommunications industry in connection with his Industrial Reorganization Act. This committee is again focusing on these issues but now in the context of what appears to be a consensus in the Congress to substitute market forces for regulatory oversight whenever competition is feasible. In addressing these important issues of regulation and competition, as I did seven years ago, it is necessary to place them in perspective. A statement of a new national telecommunications policy which is urgently needed and the thrust of which we support, would have a profound impact on the communications future of this nation, and particularly on AT&T (which I will refer to, together with its subsidiaries, as the Bell System).

The Bell System, as the most pervasively regulated private enterprise in our country, provides the best telecommunications service in the world at relatively low rates--rates which overall have increased during the last decade at less than half the rate of inflation. Ever since the telephone was invented in 1876 by Alexander Graham Bell, the founder of the Bell System, AT&T has maintained leadership not only in this country but throughout the world in the communications industry which that invention spawned.

It is essential, particularly at this juncture in our Nation's economic history, to reflect upon the significance of that indisputable fact. It was not long ago that we were able to take the preeminence of American industry in world markets pretty much for granted. The public assumed that American companies were world leaders, or at least very competitive worldwide, in almost every important area of economic activity--steel, automobiles, transportation, electronics--you could go on and on. Unfortunately, that is no longer true. In many of these areas, our country has lost its leadership. Indeed, we are not even competitive on a worldwide basis in some of the areas that are critical to our economic well-being, if not to our very survival.

Telecommunications is one of the few remaining major industries in which this country has maintained world leadership. There are others--computers, aircraft, and farm machinery come to mind--but the number is so few that it is startling for a country that has for so long regarded itself as the industrial leader of the world.

Much attention is now being given to the causes of this loss of industrial leadership. We recognize that this hearing is not intended to investigate that broad question. However, the subject matter of the hearing does call for devoting at least some attention to a narrower question: How has the Bell System maintained its world leadership in telecommunications at a time when many other industries in this country have lost such leadership?

The answer is increased productivity, largely the result of innovation,and an integrated organizational structure that efficiently brings those benefits to the public. Bell has been faced with nearly all of the inflationary problems that other American companies have had to face--higher wage rates, higher material costs, and soaring interest rates. But notwithstanding those problems, Bell has maintained a productivity record at or near the top of American industry throughout the period since World War II. That record continues to the present. As measured by numerous studies dealing both with labor productivity and total factor productivity, Bell's record shows productivity gains more than double the productivity gains for the American economy as a whole.

This is a remarkable record--even more remarkable when it is recognized that such gains have been achieved not at the expense of Bell's one million employees but under a labor relations policy that has allowed Bell's employees to earn wages comparable to those earned in other sectors of American industry. Moreover, these wages are paid to American workers in America. Bell does not maintain plants in other countries in order to take advantage of lower wage rates prevailing in other parts of the world; nor has it been Bell's policy to subcontract its manufacturing activities outside this country.

The productivity gains realized by the Bell System stem directly from the fact that Bell has been, and continues to be, the leading force in technological innovation in the entire world. The transistor was invented at Bell Labs in 1947, and this one invention has been the foundation of a technological revolution. Of the 18 major advances in semiconductor electronics since 1947, 12 were made by Bell Telephone Laboratories. No country (other than the United States) has more Nobel prize winners in physics than Bell Laboratories. Many other past and recent innovations which have come from the integrated Bell System will provide for future improvements in service and productivity.

We are now entering a whole new world of technology, often called the Information Age. Following the transistor which led to the development of integrated circuits, there has been an outpouring of communications and data processing technology. Most significantly, there has been a confluence of communications and data processing technology. Events are moving very swiftly. The United States leadership in this vital arena is at stake. There is tension now between this new technology and the existing obsolete laws, with the American public, the supposed beneficiary of those laws, as the loser.

The Communications Act of 1934, which was modeled after regulatory laws passed in the late 1800s and early 1900s, and the AT&T-DOJ Consent Decree of 1956, which is premised on those laws, are relics of another era. They are no longer responsive to current technology and the marketplace of the 1980's. In earlier days it was assumed that Government could draw a line between regulated communications and other unregulated activities. New technology has destroyed that line.

The Nation and its telecommunications industry, including the Bell System and the some 1500 non-Bell telephone companies, urgently need policy guidelines from Congress appropriate for the world of today and tomorrow, not 1934 or 1956. During the course of extensive Congressional hearings, beginning as far back as 1973, the fundamentals of future policy for telecommunications have become clear. Competition--reliance on marketplace forces-is to be encouraged to the maximum extent possible. The Bell System, which is responsible for so much innovation in this field, is to be allowed to compete fully and fairly to bring its innovations to the public, but with safeguards established by Congress to assure fair competition for all participants. I recall warning in 1974 that the FCC was becoming a "giant handicapper" in our industry, much as the ICC had been in regulating the railroad industry. Any new legislation encouraging a competitive environment should appropriately move the Commission away from that role by reducing regulatory involvement in the competitive telecommunications markets of today. Let me turn to three key areas of concern:

1. The Significance of the 1956 Consent Decree Settling the Antitrust Suit Brought by the United States Against AT&T.

The 1956 Decree put a fence around the Bell System, generally limiting the Bell System to the provision of common carrier telecommunication services subject to regulation or services incidental thereto. Under present circumstances, the 1956 decree, unless properly construed, will exclude the Bell System as a competitor in any market in which data processing is commingled with communications, and even from telephone equipment if that market is detariffed or deregulated. Such an exclusion would be clearly anti-competitive. To exclude such an important and innovative competitor as Bell from these markets would turn the antitrust laws, which are intended to promote competition, upside-down.

The FCC in its Computer II decision has recently construed the decree as permitting AT&T to provide so-called enhanced services in which data processing services are commingled with communication services, and to detariff and thereby increase competition with respect to terminal equipment. Much controversy has surrounded this FCC ruling and it is now before the courts. It would be most wasteful to leave this communication policy issue to the vagaries of extensive litigation with its attendant delays. It is the function and duty of Congress to decide communications policy and set the rules in the national and public interest.

Witnesses (specifically Messrs. Biddle and Spievack) have charged before this Committee (June 17) that AT&T is asking the Congress to bail us out of an agreement we struck in 1956 with the Department of Justice. The charge is unwarranted. First, the legislation that Bell asked Congress to consider was the Consumer Communications Reform Act - legislation that confirmed the regulated monopoly status of communications and required no modification of the Decree. Second, the coming of marketplace competition to the communications industry is the result of emerging technology to blend computer, data processing, transmission and switching capabilities and has brought non-common carriers into the communications industry. That development posed a major policy dilemma for the FCC and now for the Congress. Should regulation be expanded to embrace the computer and data processing industries? Or should the new technology be seized upon to encourage alternative sources of supply that would supplant the need for regulation? Similarly, developments in transmission and switching technology have permitted the emergence of competing inter-city carriers. The FCC has recognized existing or potential competition in every market, and is struggling valiantly to change its policies and rules to reflect current conditions. But it operates under a law passed half a century ago that contemplates only a pervasively regulated monopoly environment.

This is the context in which Congress is reconsidering the legislative framework in which communications services are to be delivered to the public. This is the background against which the Commerce Committee developed and favorably reported S. 898 - legislation which would separate the industry into regulated and competitive segments and modify the Decree to recognize the new policy favoring competition.

Finally, Messrs. Spievack and Biddle, in implying that Bell should be forever confined to the role it played a quarter century ago, ignore the position of the other party to that 1956 agreement. The Department of Justice while disagreeing with the FCC's interpretation of the Decree, has represented to the District Court that if the FCC or the Bell System want the Decree to be modified a "proper recourse is for AT&T to seek relief from Congress in the form of an amendment to the Communications Act." (Dept. of Justice Brief dated June 25, 1981 in United States v. Western Electric, et al. (D. N.J. No. 17-49) (p. 22).

2. The Effectiveness of Structural Reform in Encouraging or Maintaining Competition in a Deregulated Environment.

The charges of anticompetitive cross-subsidy made by competitors of the Bell System have not been proved, and they almost invariably rest upon unsound economics. But those charges have been reiterated so often that cross-subsidy has become a major concern of the Congress in the consideration of any legislation in this area.

The structural reforms embraced in pending legislation are the result of detailed analysis by many Senate and House Committees, by the NTIA, by the FCC and independent consultants. The structural changes mandated for the Bell System are designed to remove any potential for cross-subsidies by separating regulated basic network activities -- including product development and manufacture -- from unregulated competitive activities -- including product development and manufacture.

This approach deals comprehensively with even the possibility of cross-subsidy. An example is the requirement of equal access to local distribution facilities coupled with the unlimited right of resale and sharing of Bell System service. These requirements remove even the theoretical incentive to cross-subsidize. If access services or facilities are priced too high, Bell's unregulated affiliate would be disadvantaged just like its competitors. If they are underpriced, the Bell System would subsidize its competitors. Moreover, the FCC is given broad oversight authority to police the regulated/unregulated border and insure fairness.

Other protective provisions include the requirements for the creation of and the standards for the behavior of a fully separated affiliate through which the Bell System would provide unregulated services. Specifically, the creation of one or more fully separated affiliates would be required, subject to plans approved in advance by the FCC. Any such affiliate must have a separate financial and organizational structure, including its own marketing, sales, maintenance, and operations. After a transition period it will provide its own (or acquire from a non-affiliate) applied research, development, and final assembly of products, and will supply most, if not all, of its subassembly and basic component needs. This Congressionally-imposed program represents the most massive restructuring ever imposed on any American industrial enterprise.

For example, attached to this statement is an appendix which lists many examples of the protective provisions included in S.898 as approved by a vote of 16 to 1 in the Senate Commerce Committee last week. These requirements and others set forth in S.898, which are most extensive, are designed to prevent abuse of the competitive market by the Bell System.

We believe that these protective provisions go well beyond the minimum that would be necessary to meet the objective of preventing cross-subsidy. Excessive restrictions on the Bell System would unduly reduce productivity and economic efficiency, and thus Bell's capability to compete. To that extent, such restrictions could become anti-competitive. It should also be borne in mind that under today's situation, there is no subsidy of Bell's competitive business by its so-called monopoly business (considered to be the local exchange distribution facilities). Indeed, the situation is just the opposite -- Bell's competitive intercity services are providing very large subsidies to the local exchange business through the separations formula prescribed by the FCC which over the years have helped keep rates low for local service. Competing intercity carriers do not bear a comparable burden.

All of these matters are the product of extensive study over many years and now represent the considered judgment of those most familiar with the industry. None of the issues before this committee is new. I refer to them here only to emphasize that a consensus judgment appears to have emerged that the legislative framework will adequately protect consumers and competitors against the potential for abuses by the Bell System, real or imagined, in the deregulated environment that would be created.

3. The Possible Impact of Legislation on the Pending Antitrust Litigation Brought by the Department of Justice Against AT&T.

The Department of Justice suit (United States v. AT&T, et al., D.D.C. 74 C 1698) charges violations of the antitrust laws and asks for total divestiture of all local exchange network operations. This proposed divestiture of about two-thirds of present Bell System total investment would destroy the integrated network, with seriously adverse affects on the quality and efficiency of telephone service in the United States.

Virtually all of the Department's charges relate to matters such as interconnection, pricing and procurement which have been before regulatory agencies and resolved since the Department filed its suit in 1974. The charges arose out of a period of uncertainty and regulatory turmoil following the FCC's initial orders introducing an inconsistent mix of regulation and competition into the intercity and terminal equipment markets. The Bell System's conduct did not constitute antitrust violations at all but was reasonable in the context of attempting to comply with the uncertain regulatory situation prevailing at the time. We are confident of our position in the courts.

Even if there were any activities at that time that could be found to be violations of the antitrust laws, there is no basis in our view for any relief in the form of divestiture or restructuring of the Bell System by the antitrust court. Divestiture plainly is not necessary to cure the antitrust violations alleged, even if they should be found to have occurred, because virtually all such violations relate to matters that have long since been resolved through the regulatory process. And divestiture could not, in any event, be justified in terms of the public interest in the quality and efficiency of the service provided by the integrated Bell System.

We believe that the question of changes to be mandated in the structure of an industry as vital to the economy as telecommunications is a matter for the Congress. A legislative determination of the future structure of the Bell System should end the matter until Congress acts again. We do not believe it sensible or fair to expose the Bell System to double jeopardy by permitting the Department of Justice suit for divestiture to proceed. The same view on this issue was recently stated by Griffin Bell, formerly a federal judge and the Attorney General, in his June 16, 1981, testimony before the Senate Commerce Committee.

There is urgent need that Congress establish ground rules to govern the telecommunications industry in the crucial years ahead. Only Congress can provide these ground rules swiftly and with unquestioned authority.

Absent legislation, there will be continuing uncertainty in regulatory proceedings and lengthy court reviews of administrative orders. To permit this situation to continue would be a great disservice to the Nation. This is a time when the resources of private enterprise should be invested in meeting the challenges of rapid inflation, substantial deficits in our balance of payments, and the need for sophisticated electronic information and communication systems for the economy generally and more specifically for our national defense and security needs. Certainty and stability in national telecommunications policy is urgently needed. The scientists, engineers and businessmen of the Bell System and the other large and small enterprises engaged in the markets of the Information Age should be focusing their energies on innovation, increasing productivity and competing in domestic and world markets and not to the continuing regulatory, Congressional and legal battles waged for more than a decade. The technology and the markets are moving too fast to permit continued drift and uncertainty at a time when foreign competitors, under no such disability, challenge the United States for leadership in international and domestic markets. Only a clear statement of Congressional policy would afford U.S. business certainty and renewewd opportunity.

I would like to conclude by quoting a recent statement of Fletcher Byrom, Chairman of the Board of Koppers Corporation:

> "Name two American industries that stand out from the pack at a time when we are losing primacy in a number of international markets. One would certainly have to be the computer industry, which is years ahead of its overseas competitors. And anyone who has tried to place a telephone call in a foreign land knows that we in the United States, to use an only slightly outdated phrase, get more than our nickel's worth.
>
> "Now for part two: Name two industries that were prime targets of antitrust litigation in the 1970s. Unprofessionially, I supply the answer: our foremost manufacturer of computers and our foremost provider of telephone service. These are called monopolies by some. Some say that the monopolies lead to inferior products and services, and to higher costs for consumers. I want 'some' to explain to me how it is that these two so-called monopolies have made their

> products and services the envy of the civilized world and have at the same time lowered the cost, in terms both absolute and relative, of what they furnish forth.
>
> "What we seem to be saying to the beleaguered corporation is this: You must be strong enough to compete against giant foreign combines in stateowned or state-subsidized industries, but not so strong as to threaten the least efficient domestic producers in your own industry."

Thank you for the opportunity to appear here today.

APPENDIX TO STATEMENT
OF HOWARD J. TRIENENS, AT&T

COMPETITION PROTECTION PROVISIONS OF S.898

PROVISIONS AIMED AT REMOVING THE INCENTIVES AND OPPORTUNITIES FOR ECONOMIC CROSS-SUBSIDY

General Powers of Commission

- The FCC is empowered to review the petition of any dominant regulated carrier to establish a fully separated affiliate. No such FSA will be deemed to be established until the Commission finds that the relationships comply with the separation requirements of the bill. The Commission must act on such petitions within 180 days after filing. (Sec. 227(e) and 228(a)).*
- A dominant carrier may not offer deregulated non-basic telecommunications services, facilities or products, or services, facilities or products, incidental to telecommunications, except through a fully separated subsidiary. (Sec. 234(e)(1)).**

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* All citations refer to S.898, April 7, 1981.

** A dominant regulated carrier may offer basic telecommunications services and any other service or equipment permitted by the 1956 Consent Decree before the date of enactment.

- An accounting system is required which ensures that there is a complete and proper allocation of all revenues and costs (including costs incurred before enactment) between unregulated and regulated goods and services. Such accounting system must be established by the Commission within one year of the date of enactment and must ensure also a complete separation between all costs related to the regulated offerings of a dominant carrier and all costs related to the deregulated offerings of its fully separated subsidiary. (Sec. 220(a)(2) and 228(b)(3)).
- No dominant carrier may engage in any resale activity except through a fully separated affiliate unless permitted by the Commission. (Sec. 204(b)).

Specific Structural Requirements

- A fully separated affiliate must have separate employees, officers, and directors (except one director) from its dominant carrier or other affiliated organization. (Sec. 227(1) and (2)).
- A fully separated affiliate must have not less than five members of its governing board not more than 50% of whom are officers or employees of the FSA. (Sec. 227(a)(3)).
- A fully separated affiliate must prepare financial statements in compliance with federal financial reporting requirements for publicly held corporations, file such statements with the Commission and make them available for public inspection. (Sec. 227(a)(4)).
- A fully separated affiliate must maintain books, records, and accounts separate from its dominant carrier or other affiliated organization. (Sec. 214(a)(4)).

- A fully separated affiliate must not own real or personal property in common with its dominant carrier or other affiliates except international facilities. (Sec. 227(a)(6) and (d)(1)).
- A fully separated subsidiary must carry out directly or through non-affiliates or other FSAs its own marketing, sales, maintenance operations, manufacturing and applied research and development relating to services, facilities and products offered by such FSA except institutional advertising. (Sec. 227(a)(5)).
- A fully separated affiliate must not engage in any joint sales or marketing of a service, facility or product with its dominant carrier or other affiliates except institutional advertising. (Sec. 227(d)(2)).

Intercompany Transactional Requirements

- In addition to its other powers, the Commission is given explicit authority over a dominant carrier and its affiliates (*e.g.*, Western Electric and Bell Telephone Laboratories) to deal with anticompetitive practices between any fully separated affiliate and the dominant regulated carrier and its affiliates and to protect users in connection with such dealings between such entities. (Sec. 202(c)).
- To expose and eliminate cross-subsidies, business dealings involving the sale, exchange or leasing of property, the lending of money or any extension of credit, the furnishing of goods, services and facilities or the transfer of any assets between the regulated parts of the Bell System, including Bell Telephone Laboratories and Western Electric, and any fully separated affiliate must be fully compensatory (*i.e.*,

cover costs), must be on a contract basis, and must be fully auditable. These contracts must be filed with the Commission, and the Commission shall make public any such interaffiliate contracts to the extent necessary to facilitate enforcement of the "fully compensatory" test. (Sec. 227(b)).

- To the extent that a dominant carrier or its affiliates deal with a fully separated affiliate, it must deal with non-affiliated entities in a nondiscriminatory manner with no preference arising out of affiliation. (Sec. 227(c)).
- The Commission must approve the assets, including capital, proposed to be transferred to a fully separated affiliate as fairly and properly valued. (Sec. 228(b)(3)(A)(iv)). The assets are to be valued by an assets valuation board composed of a state commissioner, an FCC representative and a representative of the affected dominant regulated carrier. (Sec. 228(c)(5)).
- After 6 years from the date of enactment, a fully separated affiliate may purchase components or subassemblies from an affiliate such as Western Electric if, and only if, the affiliate also offers the same type of subassemblies or components to non-affiliates on the same rates, terms and conditions. (Secs. 228(c)(3) and (4)).

Requirements for Dealing with Other Entities

- In response to a reasonable request, a carrier is required to interconnect its regulated services with any telecommunications carrier, facility or customer premises equipment and must do so without unreasonable or anticompetitive discrimination with respect to charges, terms and conditions. (Sec. 207(a)). The Commission shall have the power to approve the manner, rates, terms and conditions of such interconnection and to prohibit discrimination. (Sec. 207(b)).

- No carrier may maintain any restrictions on resale or other use of its regulated services. (Sec. 204(a)(2)).
- A system of exchange access charges is to be established by the Commission and a Joint Board within a year of the date of establishment of the Joint Board. The access charges are to achieve equitable treatment among all telecommunications carriers, prevent any cross-subsidy of interexchange services by exchange services and assure that any payments and cost assignments are open and accountable to the public. (Sec. 222(a), (b) and (c)).
- Not later than four years after enactment, the final assembly, research and development, and software programming in support of services or equipment required to be offered by a fully separated affiliate or a non-affiliate must be provided by an FSA. (Sec. 228(c)(1) and (2)). After six years, subassemblies and basic components of equipment required to be offered only on an unregulated basis through a fully separated affiliate must be provided by an FSA unless the dominant carrier or its affiliates offers the subassemblies or components to non-affiliates at the same charges, terms and conditions. (Secs. 228(c)(3) and (4)).

PROVISIONS AIMED AT REMOVING THE INCENTIVES AND OPPORTUNITIES FOR INFORMATIONAL CROSS-SUBSIDY

Requirements for Disclosure of Technical Information

- Dominant carriers, as well as any affiliates that provide regulated telecommunications services, must file with the Commission technical information about their regulated telecommunications networks, including operational protocols and technical interface requirements. Other entities desiring to use or interconnect with the carriers' network must be given access to that information, subject to national defense and security requirements. This information must be kept up-to-date by the dominant-regulated carrier. (Sec. 216(g)(1)(A)).

- Such information may not be disclosed to a fully separated affiliate before filed with the Commission and until a full separation from the dominant carrier is achieved. (Sec. 216(g)(1)(B)).
- Dominant carriers must notify the Commission of the adoption of any material change relating to such information and provide summaries of construction programs. (Secs. 216(g)(1)(A)(i) and (ii)).
- The Commission is empowered to require the filing of any additional technical information by a dominant carrier and any affiliates that provide regulated telecommunications services should disclosure of such information be found necessary. (Sec. 216(g)(1)(A)(iii)).

Requirements for Disclosure of Commercial and Financial Information

- A dominant carrier must disclose its plans to construct new facilities or to otherwise extend or expand its network if such plans affect interconnection to regulated services. (Sec. 216(g)(1)(A)).
- Commercial information acquired by a dominant carrier by virtue of its provisions of basic telephone service

(e.g., address lists, lists of interconnecting customers, etc.) which would provide an unfair competitive advantage may not be disclosed (directly or indirectly) to a fully separated affiliate. The Commission may require specific categories of information (e.g., directory listing) to be made available to all interested parties (including the FSA) at the same time at reasonable non-discriminatory charges, terms and conditions. (Sec. 227(f)).

TRANSITIONAL REQUIREMENTS

- The bill finds that although full deregulation of all interexchange services may eventually be achieved, there should be continued regulation of carriers which offer telecommunications services in an area or market not subject to effective competition as determined by the Commission or carriers which offer basic telecommunications services until such time as there is effective competition or universal provision of basic services at reasonable prices can be ensured. (Sec. 201(a)(3)).
- The bill creates an elaborate process by which the Commission must establish and implement a transition plan. (Sec. 201(b)). The FCC must give prior approval to the creation and operation of any fully separated affiliates. This includes prior approval of an accounting system (Sec. 201(b)(2)(B)), ascertainment of compliance with the conditions of structural separation (Sec. 201(b)(2)(C)), the classification of carriers (Sec. 201(b)(2)(A)), a plan for integrating federal and state interexchange rates (Sec. 201(b)(2)(D)), financial and procedural safeguards to assure reasonable charges

for basic services (Sec. 201(b)(2)(E)), and practices and procedures for exchange access charges (Sec. 201(b)(2)(F)).

SANCTIONS

. The bill explicitly authorizes two types of sanctions. These give the Commission broad flexibility to match any violation of the foregoing limitations and requirements with an appropriate penalty. These sanctions are (1) cease and desist orders, and (2) forfeitures and fines.

- Cease and Desist Orders: The Commission retains the power it now has under the 1934 Communications Act to order carriers to cease and desist from violations of the Act, including now the structural, accounting, transactional, marketplace or informational protections as amended by the bill.
- Forfeiture and Fines: The Commission can order refunds or forfeitures and impose fines of up to $500,000 on a carrier for violations of the Act. (Sec. 226(f)(1)(A)). Each fine or penalty the Commission is authorized to impose is increased substantially by the bill. (Sec. 226).
- In addition two new penalty provisions were added: Any violation of the provisions of Sec. 209 which require a carrier to make interconnection with any other carrier, facility or customer premise equipment on non-discriminatory terms is punishable by a fine of up to $250,000. (Sec. 209(c)).
- Any violation of the provisions of Sec. 227 which

set out the separation requirements between any fully separated affiliate and its dominant carrier and other affiliates is punishable by a fine of up to $1,000,000. (Sec. 227(i)).

Congressional Oversight

- Congress will conduct oversight hearings every six months to ensure that the FCC fully carries out the intent of Congress in the implementation plan, Sec. ___, amendment to be supplied by Senator Riegle.

Senator MATHIAS. As those of you who are familiar with the Senate bell system are already aware, there is a rollcall vote in the Senate, and so, we will take a short recess so that I can go to the floor and vote.

When I return, the second panel will be asked to testify: Mr. Lee Selwyn, Mr. William H. Melody, and Mr. William J. Baumol.

We will stand in recess for 10 minutes.

[Recess taken.]

Senator MATHIAS. The committee will come to order.

We will ask Mr. Lee Selwyn of Economics & Technology, Mr. William H. Melody of Simon Fraser University, and Mr. William J. Baumol of Princeton to please come forward.

Mr. Selwyn?

STATEMENT OF LEE SELWYN, ECONOMICS AND TECHNOLOGY, INC., BOSTON, MASS.

Mr. SELWYN. Senator Mathias, I appreciate the opportunity to appear here this morning.

I prepared and filed with the committee staff a written statement on Wednesday and would like to summarize that briefly, if I may. I would also like to address in that summary some of the specific remarks made by the two prior witnesses as they relate to some of the issues which I have raised in my testimony.

Senator MATHIAS. Your written statement will, of course, be included in the record after the panel discussion. That applies to the other two witnesses on this panel also.

Mr. SELWYN. I think the essential question that surrounds the legislative efforts in the communications area relates to issues of the extent of competition which now exists and which may exist in that industry, the extent to which the various possible policy solutions both in the antitrust and legislative areas may enhance the competitiveness of the industry, and the extent to which any of these legislative solutions may work to the detriment and operation and integration of the Bell System.

I would like to first briefly address the integration issue as raised this morning by both Dr. Tanenbaum and Mr. Trienens. I do not think that the issue is quite as clear as it was presented by the A.T. & T. witnesses.

I should point out that in these remarks I am not advocating in any sense either outright divestiture or even the solution that is proposed by the Justice Department which would fragment the Bell System, but I do think it is important to recognize that approximately 20 percent of the local exchange service in this country is today and has been for many years provided under exactly the scenario which Dr. Tanenbaum suggested would cause a disintegration of the network.

Independent telephone companies which provide only exchange service, much along the same lines as that envisioned by the Justice Department, now serve approximately 20 percent of telephone subscribers in the United States. Those services are integrated and form an integral part of what I believe Dr. Tanenbaum described as the finest telephone system in the world.

There are technical standards that govern such interconnection, and it works, it has worked for a long time, and it continues to work.

Insofar as access to that network by other suppliers and by users of customer-owned equipment is concerned, I think the experience we have already had with a multiplicity of suppliers, to the limited extent to which it exists, demonstrates that from a technical standpoint there is no consequential problem associated with the use of non-Bell System facilities and services with the Bell network.

In the area of competition, the Senate Commerce Committee's bill, I believe, construes the existence of competition under too narrow a view of that concept, one that is highly advocated by Bell.

Under this view, virtually any entrant in the industry, irrespective of his size, of his capacity to serve, or his market power relative to that of Bell, makes the industry competitive. This clearly is not the case.

The extent of competition in the industry is simply not addressed in the Senate bill. It is merely assumed that competition exists to a point where it will serve the purpose that previously had been served by economic regulation or rate regulation.

From the consumer's standpoint, competition clearly does not serve that purpose. We look at other industries which have been subject to deregulation of prices—and perhaps the most notable of those in recent years has been the airlines—and we see, in fact, that when a new entrant enters the market there is price competition. The Northeast corridor presents an excellent example of competition forcing prices down.

But what happens in the telecommunications area when competition enters the market? Instead of price reductions we see price increases. In the area which the A.T. & T. witnesses this morning suggested was highly competitive—in the terminal equipment area—we find that in the face of competition the Bell System is seeking, and in a few instances is receiving, authority to increase its prices by, in some cases, 100 percent or more.

In your State, for example, Senator Mathias, the Chesapeake & Potomac Telephone Co. is right now requesting what amounts to price deregulation of terminal equipment services even before any legislation or FCC rulings take effect.

A similar authority was requested by Ohio Bell and was granted to Ohio Bell, and within 6 months of the date that authority was granted the telephone company raised rates for many of its older terminal equipment products by, in some cases, as much as 175 percent.

There is no evidence that price deregulation, when it is granted to the Bell System—and it has been in a few instances—results in any price reductions. In fact, in almost every single instance that I can think of the direction was distinctly toward an increase.

In terms of the structure of the industry from the standpoint of what constitutes competition and foreign competition I think there are a couple of points that should be borne in mind.

First of all, most of the competition in the terminal equipment area—and I am using that for illustrative purposes here—was referred to this morning as coming on the manufacturing side—the foreign competition, the Japanese, the Canadian, and the European competition. It is in the manufacture of that equipment, not in the retail supply.

In fact, the Bell System itself has acquired and continues to acquire equipment manufactured by Japanese, Canadian, and Western European companies which it itself furnishes under tariff through its retail operating companies to the retail customer.

It is not at all obvious that retention of the present Bell dominance of the market in any way will alter its practice of acquiring foreign products.

The hardware cost—the cost of the manufactured product—represents a relatively small fraction of the cost of an installed telecommunication system actually paid by the customer. On the basis of data that we have collected during the course of work on State rate cases, it would appear that the manufacturing component represents something on the order of magnitude of perhaps 30 to 40 percent of total installed system cost.

The dominance of the Bell System is primarily in the retail area. That is the area in which it has an ownership of its installed base; it maintains a rent-only relationship with its customers; it resists any efforts to get it to sell equipment outright.

Because of this rent-only policy, A.T. & T. is able to perpetuate the former monopoly position, that it had developed under regulation, into the future by retaining a captive relationship with its customers.

The last area that I have addressed in my statement concerns the concept of fully separated subsidiaries and cross-subsidization.

I believe the term, "fully separated subsidiary" or "fully separated affiliate" as it is used in the language of S. 898 is, in itself, a non sequitur.

The concept of an affiliate that is fully separated simply is self-contradictory. With the Bell System management controlling both its regulated and unregulated entities, with management making resource allocation decisions among those entities, there cannot be and will not be an arm's-length relationship among these firms.

At the same time, I think it is important to understand the limitations of cost accounting in resolving the cross-subsidization issue. The accounting systems that exist today and the cost development systems that exist today in many instances actually foster rather than preclude the possibility of cross-subsidization.

Cost accounting has extreme limitations. Even in its present form it in no way prevents cross-subsidization, even to the extent that information could be collected in an accounting system, but it will certainly not prevent cross-subsidization and cannot prevent cross-subsidization when that term is viewed in a broader context.

By that I mean the effective providing of an advantage to the subsidiary or incurring of an additional cost to the customers of regulated services.

An example of this might be the case where an inexperienced employee is hired and trained by the regulated company and when that employee is fully trained and has attained a certain level of competence he is transferred to the fully separated affiliate.

Other examples include the financial integration of the utility with the fully separated affiliate, which enhances the affiliate's ability to raise financial capital; the fact that the two will file a consolidated tax return, which means that, for example, an affiliate that requires early capitalization and may sustain early losses in its first several years of operation, such as would a venture into the information area, by means of a consolidated tax return in effect be able to write off its losses immediately where any unaffiliated entity would have to simply wait until those losses were offset by profits in later years.

The issue, I think, is very complex, and the notion that cost accounting can resolve these issues exaggerates the capabilities of the accounting art as it presently exists.

In my opinion, the notion that competition exists—the presumption that it exists—that is pervasive throughout S. 898, is fundamentally wrong. If the bill is enacted in its present form, it will lead to premature deregulation of many segments of the industry and will enhance the Bell System's ability to dominate the industry over the next 5 to 10 years.

That concludes my summary.

Senator MATHIAS. Thank you very much, Mr. Selwyn.

Mr. Melody?

STATEMENT OF WILLIAM H. MELODY, SIMON FRASER UNIVERSITY, BURNABY, BRITISH COLUMBIA, CANADA

Mr. MELODY. Thank you, Mr. Chairman. I am pleased to have the opportunity to appear before the committee today.

My statement focuses primarily on the antitrust aspects of S. 898, and I will summarize the major points.

Unfortunately, in its present form S. 898 is not likely to achieve its stated objective of increased competition in the telecommunications industry; and, in fact, there is a great probability that it will have precisely the opposite effect.

The fundamental purpose of economic regulations in the telecommunications and other public utility industries is to provide a substitute for effective market competition in limiting and constraining the monopoly power of a dominant firm.

The constraints of regulation are intended not only to protect consumers of monopoly services but also to prevent that monopoly power from being extended to spoil existing and new markets that could and should be competitive.

S. 898 releases A.T. & T. from certain existing constraints provided under Federal and State regulation and the 1956 constraint decree but does not have adequate regulatory or antitrust protections to prevent A.T. & T. from using its vast monopoly power to spoil the possibility of effective competition in the potentially vast enhanced communication equipment and services market that is the evolving point of convergence of several industries ranging from computers to newspapers.

Deregulation that removes Government restrictions on effective competition is sound economic principle. If regulation is restricting effective competition rather than monopoly practices then it is restricting economic efficiency. The lifting of regulatory restrictions in airlines, trucking, and securities revealed industries that were already competitively structured.

Where a dominant firm has overwhelming monopoly power, such as A.T. & T., deregulation of the dominant firm will bring about economic inefficiency not efficiency, and I believe Mr. Selwyn has cited some of the illustrations already.

Deregulation will simply permit the dominant firm to extend its monopoly power to related markets and industries, thereby spoiling what would otherwise be competitively efficient markets.

The incentive to do so is especially compelling in telecommunications where changing demand and technology have opened many avenues for potential competition that have yet to be traveled because entry to them is controlled by A.T. & T.

In fact, the removal of existing regulatory constraints will have to be replaced by other regulations, and an increased responsibility for protecting against monopoly practices will be shifted to the antitrust area.

S. 898 provides for the establishment of separate subsidiaries by A.T. & T. for its participation in potentially competitive, enhanced telecommunications services. These subsidiaries would not be subject to regulation.

Thus, whereas the existing interface between A.T. & T.'s monopoly and potentially competitive services takes place under a regulatory scheme that encompasses both kinds of purposes, under S. 898 that interface will take place between regulated monopoly and unregulated, potentially competitive services.

The unregulated, potentially competitive services that are now dominated by A.T. & T. and that depend upon essential facilities over which A.T. & T. has a regulated monopoly will now fall solely within the province of the antitrust laws.

The antitrust laws are now expected to constrain A.T. & T.'s monopoly practices to a degree that A.T. & T. will accept substantial inroads into its dominant market share by firms supplying competitive services that require reasonable access to essential local facilities over which A.T. & T. has a monopoly.

If substantial inroads are not made by A.T. & T.'s competitors then these newly unregulated markets will remain monopolized. Thus the transition to unregulated competitive markets will require a very high level of visibility and perceived effectiveness by A.T. & T. of the antitrust laws.

S. 898 also presumes that FCC regulation of the interface between regulated monopoly and unregulated, potentially competitive services will be more effective in preventing interservice subsidies than FCC cross-subsidy regulation in the past.

As has been well documented, the FCC's 20-year attempt to implement effective accounting and cost controls of A.T. & T. in order to prevent cross-subsidy has been a dismal failure.

There is no indication that the FCC will be any more capable of preventing A.T. & T. from engaging in the subsidy of its competitive services by its monopoly services under the new separate subsidiary approach.

In both instances what is necessary is a revision of the accounting and reporting system that is applied to A.T. & T.'s services. The FCC's attempt to establish such an accounting and reporting system by revising the uniform system of accounts has been deactivated.

Clearly there is no hope for effective regulation over cross-subsidy unless a revised accounting and reporting system is implemented in advance of or at least simultaneously with the new legislation.

The legislation should require implementation of a revised uniform system of accounts by the FCC at the same date A.T. & T. establishes its unregulated subsidiaries. We must not forget that A.T. & T. has many separate subsidiaries now and existing regulation does a very ineffective job at reviewing the reasonableness of transactions among them.

The intent of S. 898 is to create market conditions that will lead to the development of competition in the markets that are being deregulated.

If competition is to develop all competitors must have equal access to local exchanges under reasonable terms. To insure this the bill should specify that at the time of implementation all A.T. & T. local companies will establish a uniform set of access services and charges that are equally available to all competitive firms, including A.T. & T.'s restructured intercity carrier subsidiary.

In keeping with the objective of creating effective competition in unregulated markets, the bill should more strongly assert this objective. It should direct both the FCC and the Department of Justice's Antitrust Division to monitor competitive developments in these unregulated markets and require that annual reports be submitted to Congress assessing the progress that has been made toward the establishment of effectively competitive market conditions.

The Department of Justice should be given a mandate to give this industry special attention and to be especially vigorous in pursuing antitrust violations.

In this regard the bill might state that the current Justice antitrust suit against A.T. & T. is entirely consistent with the objective of the bill but simply reflects pursuit of a different path to effective competition that should be considered by the court on its merits.

Finally, the bill should specifically provide that in the event of future antitrust violations by A.T. & T. that are established in private antitrust suits the court should consider structural relief through divestiture as a solution.

It is clear that if the objective of S. 898 to establish unregulated competitive markets in certain telecommunications service and enhanced service markets is to be implemented effectively the strengthening of regulatory provisions and the specification of an expanded role for antitrust are essential. I recommend to the committee that such changes be made to S. 898 before final adoption.

Finally, I would like to make two brief comments on the statements of the A.T. & T. representatives in the earlier panel. Specifically, the view of A.T. & T. of developments at the FCC regarding competitive tariffs reflect I think a particularly self-serving view of that history.

I believe an independent review of the history would clearly show that the results have clearly demonstrated that A.T. & T. has filed an endless array of continuing anticompetitive prices that the FCC were able to conclude were anticompetitive but not do anything about.

With regard to the basic notion that any kind of separation of A.T. & T. involving divestiture of any kind would involve some kind of physical chopping, I think that is a complete misrepresentation.

No proposals that have been made by anyone would require the physical chopping of facilities. The proposals all refer to simply changes in ownership arrangements.

At the present time the industry is made up of not only A.T. & T. but 1,500 independent telephone companies, many farmer lines, and other companies, all of whom supply portions of an integrated service. In fact, in Canada the same situation takes place involving not only government agencies at Federal, provincial, and local levels, but various kinds of companies.

The question that is addressed through questions of divestiture is one of ownership arrangements; it is not one of physical chopping.

Thank you.

Senator MATHIAS. Thank you, Mr. Melody.

Mr. Baumol?

STATEMENT OF WILLIAM J. BAUMOL, PRINCETON UNIVERSITY AND NEW YORK UNIVERSITY NEW YORK, N.Y.

Mr. BAUMOL. Thank you very much. I join with my colleagues in expressing my gratitude for the opportunity to appear here at this historic moment in the future of the telecommunications industry.

I will deal primarily with the subject that has been mentioned several times this morning but only in passing—with the issue of cross-subsidy—but unavoidably I will touch on related matters such as entry, scope, and the appropriate role of regulation.

The idea of cross-subsidy is that some prices of an incumbent firm—the Bell System in this case—may be too low and in that way can impede competition. But it must not be forgotten that prices can also be too high.

The interest of any entrant is to force as high a price on the incumbent as he can get away with. This avoids the need for any efficiency on his part and guarantees him profits unearned by merit. Predictably, entrants almost always seek to impose rules which make prices unjustifiedly high using the term "cross-subsidy" as their slogan.

Economists virtually all reject these anticompetitive criteria, pointing out that consumers are served better by low prices than by high ones. After all, competition is not an objective in itself; its purpose is to make things better and cheaper for consumers.

This issue—the issue of cross-subsidy—is complicated where economies of scope are present—that is, where a multiproduct firm obtains efficiency benefits by the very multiplicity of products that it provides.

It means, in effect, if such economies are present, that a firm producing 50 products has a technological and hence a cost advantage over a firm offering only 20, even if both firms are equal in competence of management and of techniques.

Surely it is appropriate for any such true efficiency advantages of an incumbent to be passed on to consumers in the form of lower prices. Such lower prices, while painful to the entrants who do not benefit from the advantages of economies of scope, do not in any economic sense constitute a cross-subsidy. Even if the incumbent's efficiency advantage is attributable to economies of scope rather than special ability, that is exactly what would happen in a completely free market whose accomplishments historically are attributable in large part to the fact that the free market always awards any task to the most efficient supplier, whatever the source of its efficiency may be.

It is important to note that in fact there does exist a clear-cut and workable criterion of cross-subsidy. It is founded solidly on economic analysis and is widely utilized by the courts.

I refer to the criterion most recently associated with the work of Professors Areeda and Turner of the Harvard Law School which holds that the price of a service involves no cross-subsidy if it covers all of the costs caused by supplying the unit of service sold at that price. That is, if supplying a customer raises total company outlays by $17 then there is no cross-subsidy so long as price is at least equal to $17.

The logic is clear, and it is clear that any higher price rule is a protectionist umbrella which is designed to keep inefficient entrants out of trouble.

Thus there is a criterion of cross-subsidy which is fully available and emerges from the legal and economic analysis. Its workability is demonstrated by repeated use by the courts.

Attempts by entrants to substitute regulatory restraints or artificial tests which impose higher prices on consumers must be recognized for what they are—as an attempt to substitute a cartel-like protective arrangement for the rigors of true competition. Naturally, this will all be done in the name of true competition in the process of subverting that competitive process.

Naturally enough, entrants wish to be protected from effective competition of an incumbent as they enter the telecommunications arena, and this is perfectly understandable. They also wish to be protected from the entry of the incumbent into areas from which it was previously restricted.

One can understand their distaste for true competition with a large company with its economies of scale and scope and reputation for efficiency.

Thus, they can be expected to advocate dismemberment of the company, or, if they fail in this, that all of the incumbent company's operations be subjected to tight regulation while others are left largely free to act as they wish.

But it should be recognized that such a solution leaves us with the worst of all possible worlds. It is worse than the old regulated monopoly because it deprives the industry of the economies of scale and scope that may be available. It is worse than true competition because it protects inefficient firms and keeps prices artificially high.

If there is to be a deregulated portion of the industry it is essential that it be extended evenly to all participants. This must be true of relevant activities of the Bell System which must be left to the market mechanism and the surveillance of the antitrust authorities.

This surely is what is done in other industries containing one or more firms considerably larger than the rest. No one in his right mind suggests in those cases that large firms alone should be hampered by tight regulations which delay their price decisions at every turn under rules ostensibly designed to prevent cross-subsidy.

The cross-subsidy issue is a real one. In principle, it is indeed possible for an incumbent firm to compete unfairly by adopting uncompensatory prices for its competitive services, but the antitrust authorities are perfectly capable with dealing with the issues elsewhere in the economy, and there are no reasons for special Government intervention into telecommunications on cross-subsidy grounds.

The issue is merely one focal point of the struggle to prevent true competition in telecommunications and to substitute a governmentally enforced cartel which provides a haven for inefficient entrants.

That such an arrangement will bring no benefits to consumers is obvious enough, but it should also be recognized that it will constitute yet another handicap which the U.S. economy will have to overcome in its critical struggle to retain its place in its own markets and its share in the markets of the world.

Thank you very much.

Senator MATHIAS. Thank you, sir.

Let me start the questioning by asking the chairman of the committee if he would like to propound any questions at this point.

The CHAIRMAN. Thank you very much, Mr. Chairman. I would suggest you proceed. I cannot be here but a few minutes.

Senator MATHIAS. Thank you.

Mr. Selwyn, you detailed a number of what you felt were shortcomings in the provisions of S. 898 that purport to create an affiliate fully separated from A.T. & T. What do you think specifically should be modified in that bill which would better preserve competition in the unregulated market?

Mr. SELWYN. I think the critical assumption or presumption that underlies the language of S. 898—that competition already exists—should be reversed. That is, the presumption should be that a particular segment of the market, coming out of 100 years of protected monopoly status, remains highly monopolistic, if not totally monopolistic, and remains dominated by a single supplier with pervasive market share and extensive market power, unless affirmatively shown by the proponent of deregulation that this condition does not exist.

I have indicated in my statement that tests can be developed and have been developed affirmatively concluding that the market condition is now sufficient to justify the relaxation of price regulation.

I am not as concerned as Professor Baumol appears to be with the possibility that the fully separated subsidiary would charge prices that are below cost in markets in which it competes with others.

My concern is quite the contrary. My concern is that in a market in which competition is insufficient, where competitor capacity to satisfy demand is insufficient, without price regulation the fully separated affiliate operating in an unregulated environment will set prices substantially in excess of the incremental cost. I certainly share Dr. Baumol's view that incremental cost should serve as a standard for measuring the extent to which prices may be subsidized.

The point is that I think we start out with the presumption that we are dealing with an evolving, fledgling, competitive industry where the dominant firm historically controlled such a large percentage of the market and maintained such extensive market power that we start with the assumption that that condition exists and allow regulation to be relaxed only when it is affirmatively demonstrated that competition will take over in protecting consumer interests.

Senator MATHIAS. You suggest the creation of an interim accounting principles board to evaluate A.T. & T.'s cost accounting system. How would you staff such a board? What sort of composition would it have?

Mr. SELWYN. The concern I have expressed is that the accounting issues are sufficienty complex, and, as I have explained, the art of accounting itself is sufficiently limited that I do not think any system that could possibly be established within a 1-year period could satisfy the needs of assuring the arm's-length relationship in all transactions among the various affiliates, regulated and unregulated, of the Bell System.

What I propose is that a board be established to, in effect, permit the accounting system to evolve as experience develops over the years with this new structure of A.T. & T.

I would propose that it be staffed by representatives of the FCC, of A.T. & T., and of those with an interest in assuring the kind of arm's-length relationship that I believe the drafters of the proposed legislation intended. That would include representatives of consumer interests, large and small, and of competitive interests.

I think we also have to recognize that when I speak of consumer interests I am speaking of the full range of consumers, from the individual household with one telephone to small business, large business, large institutions, State, local, and Federal Governments. All of these are consumers. They all have an interest in making sure that no one dominant supplier operating in an unregulated environment is able to utilize its monopoly power to extract excessive prices.

In fact, should excessive prices become the norm of this industry under deregulation—which I believe it will if the legislation as presently constituted is enacted—I think that would go a very long way toward disadvantaging the remainder of the economy in its ability to develop and compete internationally.

Senator **Mathias**. You refer to this as an evolutionary process. What, in your mind, would be a reasonable period of time for such a board to accomplish its basic work?

Mr. **Selwyn**. I think it is difficult to answer that because of the connection between the need to establish an effective cost accounting system and the ultimate determination of those portions of this industry which are competitive, can be competitive, or cannot be competitive.

For example, in research which I referred to in my statement that was done for Congressman Wirth's subcommittee, we concluded that, looking at the terminal equipment market segment generally, at least through 1985 the Bell System would be in a position to charge prices some 200 percent over the marginal or incremental cost of the service. On the basis of that conclusion, we believe that we do not now have a competitive market.

As the decade goes on and as competition begins to develop in certain pockets of that market, I think it will become clearer the nature of the affiliation and the nature of the separation that is required.

I really do not think it is possible at this point, in view of the potential for Bell to maintain dominance of this market and the uncertainty as to where competition will develop and where it will not develop, to firmly cut off the point in time at which the accounting system can be frozen.

We have only learned, for example, just within the last year how the present uniform system of accounts can be utilized by Bell to conceal cross-subsidization in the sense of forcing customers of newer products to, in effect, pay for premature retirements of older products that are themselves a consequence of the Bell System's pricing practices in this area.

We will learn new things about limitations and capabilities and needs of the accounting system only as the operation of the new structure of Bell evolves. I do not see how we can put a firm cutoff on that.

Senator **Mathias**. While we are talking about the accounting system, and in light of your special knowledge, I am wondering if you are aware of any instance when the U.S. Government, which is the principal customer of A.T. & T., has been overcharged.

Mr. **Selwyn**. I will have to answer that in a general way. The U.S. Government for the most part—and there are a few exceptions—is purchasing the same services as are offered to the private sector and at the same rates as are offered to the private sector.

There is growing evidence around the country that, given the opportunity, given the regulatory authority to do so, the Bell System will seek to establish rates that are several hundred percent in excess of the costs as indicated by their own studies.

The Federal Government is paying those rates. The Federal Government was subject to the same increases of anywhere from about 100 to 175 percent in Ohio that were a direct consequence of the Ohio Commission's decision to allow deregulation of prices.

The Federal Government and all other consumers, large and small—corporate consumers and residential consumers—are being subjected to the same type of pricing practice. They are being subjected to a practice, which I have mentioned in my statement, which involves a plan on the part of the Bell System—which I think, incidentally, provides the single best evidence of a fundamental lack of competition in the market—whereby Bell, through repricing of equipment that was furnished to customers years ago but is still under a rent-only arrangement with Bell, forces that customer to discontinue that equipment because the price relationship between the old equipment and newer equipment, which Bell views as more important for its long-term competitive position, is reduced.

The customers are thereby induced to take the new equipment. When Bell removes that older equipment they still carry some undepreciated investment on the company's books. The equipment was usable as long as it remained in service, but once removed from service the equipment is physically mutilated or destroyed beyond reuse by the Bell companies to prevent it from entering a secondary market and competing with the newer Bell product.

The waste of economic resources associated with this policy finds its way back into the cost as developed by the accounting system, that the company now uses, which in turn finds its way back into prices.

So we are seeing a pervasive policy of overcharging and of recovering costs associated with unreasonably and inappropriately destroyed and retired equipment from the Federal Government, from large consumers, and from individual residential consumers.

Senator MATHIAS. As you know, the General Services Administration has a watchdog team which looks at overcharges to the Government in a wide variety of cases. They might not pick up higher-than-necessary prices from the causes you have just described.

Do you think increased competition would, in fact, affect such higher prices?

Mr. SELWYN. If we had competition then I think we would see what we learn in basic economics courses and even perhaps before that is supposed to happen in competitive markets—that if one firm attempts to charge a price that is too high other firms will be able to come in and set their rates below that price, thereby forcing the market price down, ultimately—if we were dealing with a nearly perfect competitive market—to a cost level.

When we see evidence that prices in that market are set not at cost but distinctly in excess of cost, that in itself allows us to conclude, I think, that competition is simply not present to a degree sufficient to protect consumers from overcharging.

The problem we have here is that we do not have competition, and merely by deregulating Bell we are not going to get competition. In fact, I think just the opposite will happen: Deregulation of Bell will permit it to pursue this type of pricing treatment for an indefinite period of time. Every indication is that the company will, under a profit maximization type of management strategy—which is appropriate in a deregulated company, and if the company is to be deregulated I cannot fault them for that—price many of its services excessively for a substantial number of years.

Senator MATHIAS. Mr. Melody, do you think that by forcing maximum separation of the A.T. & T. unregulated subsidiaries, we might lose some of the efficiencies of large-scale integrated systems?

You referred to the Canadian example as evidence to the contrary, but could you develop that just a little bit?

Mr. MELODY. Yes, Senator. The tradeoff in, I believe, the range of the debate that takes place here—and, in fact, with Will Baumol and I here I think you will get both sides of it—is that on the one hand if you pursue everything with a single integrated structure according to a single plan there may well be economies present.

Senator MATHIAS. But then to commit yourself to a degree of monopolization.

Mr. MELODY. Certainly. I think the end result is that that is the monopoly solution.

The competitive solution is that which brings about the greatest degree of separation, the greatest degree of independence of separate companies, and therefore a change in the incentives of the companies so that transactions back and forth between companies are based upon a competitive structure rather than a monopoly structure.

The tradeoff, I think, is basically one that the economic literature would refer to as the dynamic economies—the benefits of many firms pursuing many avenues, many services, and many different lines of technology as opposed to one.

The point I would emphasize is that you can bring about a separation that can be very costly but you need not do so. You need not bring about the kinds of physical separations that were implied by the gentlemen from A.T. & T.

You can change ownership arrangements and still take advantage of economies of integration. That is obvious in the system as it is and as in the system in other countries.

Right now A.T. & T. employs 24 different separate subsidiaries. It made that choice on its own in terms of the efficiency of the management of the company.

The separate subsidiaries, if they are going to be created, I think should bring about a maximum separation in terms of ownership. They should not require physical chopping of an integrated communications system.

I think the maximum separation could be achieved if there were a requirement that all of A.T. & T.'s separate subsidiaries have significant ownership shares from interests outside of those interests that were directly compatible with A.T. & T.

In fact, this rule has been applied by the FCC to other telecommunications carriers—some of the new carriers that have come in.

What this would do would be to provide a significant financial interest in the separate subsidiary in that subsidiary alone. It would be interested in having that subsidiary act as a competitor in the best interests of that subsidiary and not in the best interests of A.T. & T. as an entire firm.

I think this would then tend to at least provide a force that would be counter to the illustration that Lee Selwyn just gave us.

He gave us a situation where, under the existing structure of the industry, A.T. & T. is not behaving as it would if it were only a competitor in an actively competitive market. It is behaving as a monopolist that is operating in both competitive and monopoly markets and can shift costs from a competitive market to a monopoly market.

If indeed there was a substantial equity interest in the separate subsidiaries the equity interest would then be very concerned about the separate subsidiary deliberately imposing losses on itself for the benefit of the system as a whole because that separate interest would not benefit.

So I think it makes perfect sense to incorporate a requirement for substantial equity interests from those interests that are beyond A.T. & T. in terms of that separation. That does not require any physical separation of facilities, and you can then take advantage of economies—whatever economies would exist in the system—as we do today with many companies.

Senator MATHIAS. I understood the sharp conflict in views between yourself and Mr. Tanenbaum and Mr. Trienens on this question of physical separation, but I am going to leave that for the moment.

As we discussed earlier today, the competitors or at least not all operations are going to be "mom-and-pop" operations; they are some of the biggest corporations in the world. They are highly experienced in the antitrust environment; they know how to take care of themselves; they have the resources to defend themselves.

Why then should we have special antitrust legislation to deal with this particular problem?

Mr. MELODY. I think this is a special problem in this industry because those large interests who have come into the fringes of the communications industry have not come into the heart of the industry, and that is precisely because those large interests have recognized the enormous problems of coming in to compete with A.T. & T. in terms of the center of the industry.

If you look at what IBM, for example, has done—IBM has entered the industry only to the extent that it can provide services on the fringe that would not bring it into direct conflict with A.T. & T. It has specifically avoided getting into situations where it would require IBM with its services to be dependent upon A.T. & T.'s interconnection.

Senator MATHIAS. What kind of market?

Mr. MELODY. For example, the key to all of the services that will be supplied by all of the companies—whether it is interconnect companies or whether it is carriers supplying the enhanced services—require the use of telecommunications facilities—inter-city facilities and local facilities.

Without access to those facilities on reasonable terms and conditions all competitors are at the mercy of whoever has monopoly control over those.

To date what have we seen? In terms of the local supply we have local monopolies, and it is generally believed we will continue to have local telephone monopolies for the indefinite future.

In terms of the intercity supply—the entrants who came into the market—initially all the entrants who have paved the way have been new, small firms. They have been specifically not the biggest firms who have chosen to take the risk. The biggest firms have chosen to back off.

Over the last 20 years the biggest firms have all developed plans for entry and then backed off when they looked at the monopoly power of A.T. & T.

What has happened and what will continue to happen in my judgment is that the biggest firms will reach an accommodation with A.T. & T.; they will not challenge it on a competitive basis with the existing structure.

Senator MATHIAS. Mr. Selwyn, would you like to make a comment?

Mr. SELWYN. I would like to add just one point to Dr. Melody's comments. It is very tempting to run down a list of firms that appear to be competitors to A.T. & T. and include such firms as Exxon and IBM on that list.

I think it is also important to recognize that these firms, while large, are diversified, cover a lot of areas, and each of those activities compete for its resources.

Let us take Exxon as an example. It certainly qualifies as a large company. Exxon's entry into an area that competes with A.T. & T. is in the manufacture of a private branch exchange system which is a telephone switching system located on customers' premises for internal communication, not unlike the telephone system that serves this building.

Exxon has indicated that it expects deliveries of this system to begin sometime late next year, and it will be capable of delivering one such system a month.

What this means is that Exxon—while certainly a formidable corporation—when we look at the extent to which it is competitive with A.T. & T. we have to recognize that over roughly the next 2 to 3 years it may be able to supply in this entire country something on the order of magnitude of two dozen customers with telephone service.

It is not proper to simply look at the size of the overall corporate firm that chooses to enter some small segment of this market. One has to look at the capacity which that firm is going to be able to muster—the resources which that firm is going to apply—in this area.

What we find when we look at large firms—Xerox certainly put a great deal of money into an innovative competitive plan in the intercity services area and then, having gone to a great deal of expense, just totally backed off and removed itself from competition.

We look at other large firms that have expressed an interest in this area. While the parent itself may be large the venture in the area is miniscule by comparison with Bell. It simply does not provide an alternative to the Bell System from the standpoint of the customer. There is just not adequate capacity in the competitive fringe of the market no matter who is in it.

Mr. MELODY. Senator, may I add one final comment on that? I think we must learn from our experience.

The FCC passed its Carterphone decision providing interconnection and opening up the terminal market in 1968. It is now 13 years later, and we have a documented experience that the market is nowhere near competitive by any economic standard.

On the other hand, the FCC passed its specialized carrier docket allowing competition as a matter of policy into intercity services almost a decade ago. Yet A.T. & T.'s market share there has gone up from the mid-90's to the higher 90's in terms of percent. Competition has not developed there.

So the mere fact that one can state that the technology permits potential competition is not one that will guarantee the development of competition. If the last 10 years have been instructive it will be at least another decade before developments have occurred so that we could say the markets are competitive, if they are ever going to be competitive.

Senator **MATHIAS**. You can make a comment, but you are not going to have the last comment because Mr. Baumol, I think, wants to say something.

Mr. **BAUMOL**. Naturally. This discussion is all predictable, of course.

In all of this one must avoid confusion between competition and counting of number of competitors. The fact that in a particular industry there is a small number of competitors can have two possible explanations neither of which is obvious on its face.

It may be the result of the fact that there are barriers to entry, that there are impediments which keep competitors out either because of the behavior of the incumbent or the regulators or someone else, or it can reflect the superior efficiency of the incumbent which may not be attributable to its virtues but may perhaps be attributable to the fact that that industry offers economies of scope and scale.

If that is true—and I am merely stating that hypothetically—then in a regime in which you have complete freedom of entry and exit two things can be expected: No. 1, that the number of entrants and their size will generally not prove to be very enormous because the entrants simply cannot take advantage of the sheer economies given in my hypothetical assumption of advantages of scale and scope.

Nevertheless, the very assumption that there is freedom of entry and exit means that the incumbent may be effectively constrained in what he can do even though the number of competitors is small.

Joe Bain, one of the leading scholars in this area, has emphasized in his seminal work that economists have by far exaggerated the role of number of competitors and have underestimated the role of potential competition. I think all of the evidence strongly supports that.

Senator **MATHIAS**. The communication that is being given us is that there is a rollcall vote in the Senate. It has reached the final stages and will require jogging to get there in order to vote. However, since this dialog seems to be so natural and useful may I suggest that Mr. Selwyn go ahead with his comment on it?

I will let counsel conduct the hearing so that you can complete this. At the conclusion of whatever colloquy ensues here, we will take a recess until 1:30.

Ms. **TIFFANY**. Please proceed. I believe you had another comment to make.

Mr. SELWYN. I am reminded of how Rosie Ruiz won the Boston marathon a few years ago. She did not start in Hopkinton which is about 26 miles from the finish line; she started about 3 blocks from the finish line.

With all due respect to Professor Baumol's comments, it is really difficult to analyze the competitive nature of an industry where, by the time the starters get into the race there is one contestant three blocks from the finish line.

The Bell System retains a tremendous head-start advantage, and it is plainly apparent that the last decade has simply failed to achieve enough running room for any competitors to make a dent in Bell's market position.

Professor Baumol's position that this may explain the relative efficiency of the Bell System could be true. It could also be explained by the use of Bell's market power to prevent competitors from running in this race, perhaps wetting the track behind it.

I think what one has to appreciate is that we cannot tell at this point, but one thing we do know is that it is simply not fair to reach the kind of conclusion about the nature of relative efficiencies that Professor Baumol suggests.

I think we have to ultimately come to a cross-roads in public policy. If it is determined that the Bell System as an integrated entity is more efficient than any fragmentation of that industry, then by all means it is in the national interest for the Bell System to retain its control over the market.

In that event, regulation, in the form it has existed up to this time, perhaps strengthened to remedy some of its infirmities, is in order.

The problem I see is that we seem to have a policy that is advocated by Bell in which, on the one hand, it would retain its dominance of the market as a result of technological and technical integration and the fairly inconsequential separations that are provided by fully separated subsidiaries, and, on the other, it would be relieved from much of its regulation.

It has to be one or the other. If the market is to be competitive then let us work in that direction and restructure the industry to achieve competition, but if that is not in the national interest then certainly let us not relax the present regulatory structures simply under the general zeal to deregulate everything.

Ms. TIFFANY. Mr. Baumol, you look like you want to rejoin that.

Mr. BAUMOL. First of all let me say that I did not imply in my comments whether in fact all of this is attributable to economies of scale and scope. I said there were two possible explanations.

Let me also play the same game with Mr. Selwyn and suggest that he was implicitly introducing an infant industry argument which is one of the things that one always hears in such a case—that is, entrants who feel that they really are not capable of competing on the merits whether in a domestic industry or in dealing with foreign competitors always argue that they are handicapped by starting late in the race, that they ought to be given a decade of grace in which they will be protected from the efficient incumbent, and that after that they will have grown up. But we also know how rarely they do come out of diapers.

I might also say that structuring competition into an industry is an attractive-sounding phrase; but, again, it sounds like competition but too often turns out to be a cartel.

If in fact the free market process hypothetically were to operate without market power but nevertheless because of economies of scope and scale were to produce an integrated organization which could out-compete all comers then the true competitive process would not yield a bunch of little firms. That would be achievable only if each of the little firms were granted its little protected arena guaranteed by a Government agency or by some other means, and the consumers would end up paying the bill.

Ms. TIFFANY. Mr. Melody?

Mr. MELODY. I think it is nice to theorize that the situation could be such that if there were continuing economies of scale and scope competitive entry would not be successful. If you accept that as the basic hypothesis you should not deregulate because you are not getting competition.

One could also hypothesize that the explanation is simply the application of A.T. & T.'s monopoly power. That indeed the competition has not developed is because A.T. & T. has engaged in a series of anticompetitive practices to make sure that it has not.

As one who has studied the industry rather intensively for the last 15 years I would say there is a lot of evidence supporting that as an alternative.

If that is the explanation, one must be able to create conditions that will prevent that if competition is to actually develop, and I think a reading of the experience since the FCC changed its policies in the direction of competition clearly shows that A.T. & T. has attempted to demonstrate economies of scale. It has not attempted to demonstrate economies of scope because that term just came into our nomenclature in relatively recent years.

But they have been unsuccessful in demonstrating the existence of economies of scale as a basis for their monopoly. The FCC went through all of that when it was establishing its competition policy.

Clearly, I find it rather unpersuasive that competitors are going to enter an industry in which they themselves expect that they are inefficient, but they are deliberately going to enter an industry because they know they are efficient in comparison with the firm that is there, but they hope that somehow when they get in they will have a Government agency protect them. I do not think firms enter the market on that basis.

Clearly the FCC's policy was based upon mountains and mountains of evidence by users, potential competitors, and others documenting that communications services could be provided a lot more efficiently than they were being provided; and that evidence continues to mount.

I think any reasonable interpretation of our history and experience shows that indeed there is the potential for competition created by changing technology and demand. The reason it has not been implemented is A.T. & T.'s exercise of its monopoly power.

Unless this bill provides conditions that will prevent the exercise of A.T. & T.'s monopoly power there will continue to be an absence of effective competition.

Ms. TIFFANY. Mr. Selwyn?

Mr. SELWYN. I think it is worth just briefly listing for the record some of the practices that Bill Melody speaks of.

When the *Carterphone* decision became effective in 1969 the Bell System filed tariffs pursuant to the FCC's order in every one of its jurisdictions.

The tariffs provided that the customer may use customer-owned equipment in connection with telephone company exchange and other network services but in order to do so must rent from the telephone company a protective device, generally called a protective connecting arrangement, which was designed to somehow prevent harm to the network that might be caused by the customer equipment.

It was never really demonstrated that such harm to the network would exist, and indeed in 1977 the FCC eliminated the requirement of such devices in favor of an equipment registration program.

During that roughly 8- or 9-year period customers who sought to obtain equipment provided by a competitor were frequently confronted with a price for the connecting device that exceeded the rental they would have to pay Bell for the service they sought to interconnect, clearly impeding their ability to deal with a competitor and obviously the competitor's abililty to sell into that market.

Bell steadfastly even today refuses to engage in outright sale of equipment. It therefore maintains total monopoly control over the entire stock of inplace equipment.

When that equipment is removed from service, if the equipment is not to be reused by Bell, based on not necessarily a technological decision but a marketing decision, the equipment is subjected to physical destruction. It is therefore prevented from entering a secondary market. This is a practice that was used in the computer industry when rent-only pricing existed.

It is interesting to see that once customers began acquiring ownership of computer hardware we found a large secondary market which is a major factor in the competitive structure of the computer industry as it exists today.

The general approach to pricing that Bell continues to use—that establishes simply a cost-floor at incremental cost but would permit it to extract the maximum profit without having to show that the market is competitive—provides a further example.

The attempt to force customer movement out of their older equipment at a rate that is faster than competitors are capable of supplying replacement systems is an example of anticompetitive behavior.

I am sure I could think of others, but there is no question here but that we are not being given an opportunity to even examine an efficiency test, as Dr. Baumol suggests.

We are operating here with an industry structure that exists because of a Government-sanctioned monopoly which over the last 10 years under a modest relaxation of the prohibitions of entry has done everything in its power to use its former monopoly position and its immense market power to prevent entry from occurring. We are not being given an opportunity to see whether or not the competitive firms are efficient.

It is incorrect to assume that merely because you remove barriers to entry that competition will instantly materialize. It takes time for manufacturing capacity and for intercity network capacity to be built up.

This is further impeded only by the rent-only relationship that Bell maintains with its customers because that relationship prevents in many cases a competitor from entering into a transaction with that customer. If the customer rents some equipment from the Bell System he is often even today precluded from buying equipment from competitors to be used in conjunction with the Bell product.

All of these barriers I think have to be recognized. One can simply not draw conclusions as to relative efficiency until these barriers are relaxed and the industry is given an opportunity to demonstrate whether or not this should be a one-firm national monopoly, in which case I would absolutely agree with Professor Baumol that we should in fact encourage the situation where if one firm is more efficient we should have one firm and it should be regulated as we have always regulated national monopolies.

But we do not have enough information now to draw that conclusion. The only thing we do know is that there is no sufficient competition to justify relaxation of regulation at this time.

Ms. TIFFANY. There were a few questions that Senator Thurmond had for Mr. Baumol, and since no one is going to be here to ask any questions perhaps we should proceed with those at this time before we recess.

Since the dialog has been going so nicely—and I think it has been very useful—perhaps we can continue that. I will address a question to Mr. Baumol, but please feel free to comment on the question and perhaps give your perspectives as well, Mr. Melody and Mr. Selwyn.

In a situation where cross-subsidization is in fact occurring, will the consumers as a whole benefit from abnormally low prices, or rather will one group of consumers benefit at the expense of another group who are charged abnormally high prices to make up the difference?

In answering the question please keep in mind that the specific industry being talked about here is one where a substantial portion is regulated and thus is not subject to competitive forces to keep prices low.

Mr. BAUMOL. I certainly agree with the tenor of the question. I think all of us would agree that if there really is cross-subsidy then what must be true is that one group of consumers is benefiting at the expense of others.

I have not at any point advocated cross-subsidy; nor has anyone else. The question is: What is the appropriate criterion of cross-subsidy? I have merely argued that it is in the interest—and quite understandable interest—of entrants to try and impose artificially high standards of cross-subsidy which force the consumers directly affected to pay higher prices than they would have otherwise, and that as a result even other consumers end up paying higher prices.

Why? Because the consumers who by this artificial standard end up paying higher prices may not contribute greater revenues—they may in fact be driven from that service and contribute lower revenues, consequently meaning that other customers must make up for that loss.

So the artificial cross-subsidy standards benefit no one but the inefficient competitor who can laugh all the way to the bank.

Ms. TIFFANY. Let me follow up on that a little bit. The efficiencies of scope you had talked about were created by the existence of vertical integration. You noted in your statement that competitors will be at a competitive disadvantage because they have not achieved this kind of vertical integration and therefore we should nevertheless allow them to suffer the consequences because it will result in lower prices to the consumer.

However, in a situation where one competitor is the only one who can have that kind of vertical integration because of Government-regulated monopoly that it obtains over the heart of the operation, as A.T. & T. does over the communication lines, do you think this analysis still applies?

Mr. BAUMOL. First of all, I think that if we are to have a free market experiment then Government should get out of the business of keeping entrants out of anything.

Ms. TIFFANY. So you think the entire operations of A.T. & T. should be deregulated including local exchange service?

Mr. BAUMOL. I am not saying that, and here I will echo Dr. Melody's words, I think, with enthusiam. Where it literally is so clearly, at least at the moment, impossible to have a multiplicity of firms what is necessary is to provide very clear-cut and nondiscriminatory rules of access. That is quite a different matter.

But those are not the sort of economies of scope we are talking about. Presumably the economies of scope would derive from having a much larger multiplicity of routes, of having an organization that is capable of supporting the basic research of the Bell Laboratories, and things of that sort, into which others are welcome to enter if they can. But if the nature of the case does not permit them to enter, that is where the market forces decree that the firm which happens to be there first will have an advantage.

Ms. TIFFANY. Would any of you other gentlemen care to comment?

Mr. MELODY. I appreciate Will Baumol's comment about the fact that the new entrants have a self-interest. What I would remind him is that the established carrier has an even more powerful self-interest.

Mr. BAUMOL. They are comparable. Both roles are predictable.

Mr. MELODY. The roles are predictable; the power is different. When one examines the cross-subsidy issue one sees that the cross-subsidy problem came about not because of concern about competitors. It came about because of concern by the regulatory commission about protecting the monpoly users from paying costs that should be borne by competitive services. That was the concern of the regulatory agencies; it was not to protect competitors in any way, shape, or form; it was to protect monopoly users from incurring costs of providing competitive services.

With regard to the standards, there is a debate about which is the appropriate cost standard that a regulatory agency should use in assessing the existence of cross-subsidy to even know if it is taking place.

Quite aside from that debate, the FCC does not have an effective system of gathering cost information to know, no matter what the cost standard is.

Without a revision of the uniform system of accounts and cost reporting there is absolutely no way, if the bill is implemented, that the FCC will be able to employ standards that can effectively prevent cross-subsidy.

This relates, I think, particularly to the evolving focus of concern in the communications industry, which is access to the local exchanges. At the present time conditions and charges of access are enormously discriminatory between the access that A.T. & T. gives itself and the access it gives any other firm, and they are likely to remain so for the foreseeable future.

So if the bill is passed under existing conditions of access, under existing conditions of no information for employing any cross-subsidy standard whatever, there will be no effective competition.

Ms. TIFFANY. Mr. Selwyn?

Mr. SELWYN. I would like to pick up on this point and in particular reiterate and expand on something I said earlier in response to a question by Senator Mathias.

I have stated that the present and in my opinion almost any accounting system would be incapable of identifying cross-subsidizations whether or not we were dealing with a single entity or with separate affiliates. I think there are some examples that demonstrate that, that would probably be useful to raise.

The FCC, for example—and, I must add, with Dr. Melody's assistance—developed a structure of cost allocations in which it took all of A.T. & T.'s services and divided them into roughly 16 individual categories.

The objective here was to assure that each category earned the same rate of return. That was the standard that Dr. Melody and the FCC believed was an appropriate basis for measuring cross-subsidization.

I happen not to agree with that particular standard, but I do not want to get into that because it is not really the point I am raising.

The categorization of Bell services into 16 groups, assuming that any standard could be developed that would accomplish the test of cross-subsidization, would be limited necessarily only to measurement of cross-category cross-subsidizations. That is, if category 3 were cross-subsidizing category 6, that could be determined under some category standard.

But what of the case where the cross-subsidy was occurring within a category? It turns out that this is probably a very major element of Bell pricing practices.

In the intercity area Bell has generally reduced prices on its longer haul, potentially more competitive services and has increased prices on its shorter haul services, both of which would fall within the very same category as defined by the FCC.

Therefore, whether or not the standard itself was appropriate it could not, in fact, be used to determine whether or not this practice was going on.

As the industry develops and markets change, and some markets become competitive and other markets become more monopolistic, we will need to have a great deal of flexibility in the application of any cross-subsidization standards.

What might be an appropriate delineation for cost accounting purposes today given the present structure of the industry and the present market conditions in the industry may not be appropriate tomorrow as competitive conditions change.

One can simply not adopt a rigid cost accounting system. Even if one could be devised that would work today, one simply could not expect that that system could work tomorrow.

Ms. TIFFANY. Mr. Baumol, I understand that you are under some very tight time constraints. Would you be able to answer perhaps just two more questions?

Mr. BAUMOL. Certainly.

Ms. TIFFANY. Mr. Schwartz, the minority counsel, would like to ask a question.

Perhaps under the circumstances it might be best to have Mr. Baumol just respond, and then we can get Mr. Melody's and Mr. Selwyn's answers afterward.

Mr. SCHWARTZ. Dr. Baumol, there has been a lot of talk about efficiencies, and there seems to be an assumption that the Bell System has reached the apex of efficiency.

I wonder if you are familiar with the evidence that has come out in the Justice Department's suit, of the many instances in which the Bell management forced the Bell operating companies to take Western Electric equipment when it turned out that there were a good many other kinds of equipment that were far superior.

There has been a lot of testimony on that. I wonder if you would comment on that.

Mr. BAUMOL. I am not suggesting that the Bell System or any other company is made up of archangels who would avoid the consequences of their own inefficiencies nor that Bell is universally the apogee of efficiency. I have not even claimed that it came close to that.

Just as I have said that the entrants were acting predictably in this drama, the Bell System has been all along, too, of course.

If the Bell System management's and the entrant's roles were reversed I am sure each would have done what the other did.

Mind you, the FCC naturally would claim that in all this it was trying to protect the consumer and not trying to protect the entrant, but we know what is going on there, too.

I am not arguing that Bell is everywhere more efficient or anywhere more competent that its potential competitors. What I was talking about—and I emphasized that in the beginning—is that it has at least been alleged that there are economies which derive from the sheer magnitude of the operations and the number of different services supplied.

This is no tribute to virtue, to natural ability, to love of beauty, to boy scout honor, or to loyalty to one's mother; but if it is true, whoever happens to have captured that position can serve consumers in general more cheaply whatever that person's personal habits, integrity, kindness, lovability, or anything else. That is the issue.

Mr. SCHWARTZ. Let me make one quick comment, because of your time constraints. Much of the debate has gone on—including your theoretical comments—and much of the claims of the Bell System have been in terms of efficiency and that it operates, partly because of its size and partly because of its ability, at a more efficient level; and that it is the entrants who are trying to deprive the community of the benefits of those efficiencies.

It seems that if the Bell System is required to engage in this kind of activity then it is a much more complex factual picture in terms of efficiencies than it appears from the arguments that are often presented.

Mr. BAUMOL. I am suggesting that we should not prejudge the issue, but I would like to see the market decide the issue. Let things work out as they may.

Simply arguing that it will be settled by the market properly when the incumbent is deprived of the opportunity to exercise whatever efficiencies it may possess, if any—that is no market test; that is not competition; that is really suckering the public.

Mr. SCHWARTZ. Thank you.

Ms. TIFFANY. Mr. Baumol, I have just one more question. You referred to the Areeda-Turner criterion as useful in determining cross-subsidization. That criterion has, however, been criticized as somewhat difficult to work with, difficult to prove, causing very long-drawn-out antitrust suits where the results have been indefinite.

Given the difficulties of working with trying to do a cost analysis, do you think it might be better to rely on preventative structural safeguards as opposed to such an after-the-fact detective procedure?

Mr. BAUMOL. The trouble is that the safeguards do not prevent long antitrust suits. Even where we have them we have seen antitrust suits of magnificent proportions, sometimes involving no such issues as Areeda-Turner.

Also, the Areeda-Turner criterion, when formulated in terms of average variable costs rather than marginal costs, is not that difficult to deal with.

I think the subject has gotten important enough that I am going to leave later, so please just go on.

Ms. TIFFANY. That was the last of the questions I had. I suppose all else we would have would be the comments of Mr. Melody and Mr. Selwyn on what you have said.

Mr. BAUMOL. May I say just one more word on that subject?

Ms. TIFFANY. Certainly.

Mr. BAUMOL. There has been a lot of discussion of the Areeda-Turner test and criticism of its details; and even Areeda and Turner themselves, for example, propose the average variable cost criterion as a sort of third-rate substitute for their true marginal cost criterion.

I think this is my one basic disagreement with them because I can give very good logical arguments showing that in fact their average variable cost test is one that stands up by itself and is not a cheap version of the marginal cost test but is basically what the economist calls an incremental cost criterion; that on both efficiency grounds and equity grounds it is an entirely appropriate criterion; and that it is in fact workable in practice.

I would maintain that if one were to adopt such an explicit standard so that firms themselves could say in advance, rather than guessing: "If I charge more than that I'm OK; if I charge less than that I am doing something illegal and likely to get in trouble," that would cut down the confusion, cut down the length of court cases, and certainly cut down the frequency of court cases.

Ms. **Tiffany**. Thank you.

Are there any comments?

Mr. Melody?

Mr. **Melody**. On the matter of alleged economies of scale, scope, or efficiency of the dominant monopolist, this argument has been hypothesized for at least 15 years by A.T. & T. They have attempted to demonstrate it to the FCC time and time again, and they have been unable to do so.

So, after 15 years of trying, we are still hypothesizing that if there are those economies of scale and scope the natural monopoly may indeed be a natural monopoly.

I think we have enough experience that we need no longer sit around and wait for some more ifs, and ifs, and ifs. There has been ample time to demonstrate it. It has been evaluated in many different spheres. Virtually every public policy agency that has evaluated it has concluded that there is no demonstration of same.

So when it comes down to formulating policy, whether through legislation or regulation, I think we cannot continue to proceed on the one hand saying we would like competition and on the other hand that we would like to hypothesize that if there are economies of scale there will not be any competition.

If the premise is competition then I think you must accept the preconditions and the policies in that direction. If the premise is monopoly you must continue to regulate the monopoly.

My second point is with regard to Areeda-Turner. I would not want the committee to believe that Areeda-Turner is a universally accepted standard. The two major comments to Areeda-Turner when it was first published in the literature by economists were both very critical of it.

One, Professor Scherer, argued that it would not bring about economic efficiency and could very well bring about long-term inefficiency. Professor Williamson referred to it as a defendant's paradise.

Since then there has been a substantial contribution to the literature—to which Professor Baumol has made a significant contribution—and my assessment of the literature is the appropriate standard that is applicable to a particular firm and a particular industry depends primarily on the conditions that prevail, and different standards could be applicable under different conditions.

Finally, if variable cost were to be adopted as the standard there is ample evidence around that A.T. & T. has and is pricing below average variable cost.

Ms. **Tiffany**. Mr. Selwyn?

Mr. **Selwyn**. I think there are several points that have perhaps come out of this discussion that deserve to be highlighted.

If one accepts the hypothesis that the Bell System does enjoy significant economies of scale and scope and thereby deserves to be the dominant firm, then that certainly would explain why it has remained the dominant firm and would well provide a basis for one to conclude that it should remain the dominant firm under regulation, and that competition should be either eliminated or at least highly restricted.

The problem I am having in understanding some of the comments that Professor Baumol has made stems from the fact that I think the same industry structure that exists today with Bell as the dominant firm can be explained by many other possible factors besides the presumption of economy of scale and scope.

I mentioned a couple of them earlier, and I will not bother to repeat them. They have to do with being there first perhaps or with anticompetitive practices that it may be engaging in.

The point is that we have a dilemma right now. We cannot tell whether or not Bell's dominance is explained by a legitimate natural monopoly condition or simply because it got there first.

If any conclusion one way or the other is drawn—and I appreciate the fact that Professor Baumol felt that he, too, could not reach any conclusion on that and was not asserting that the present configuration of the Bell System is the most efficient configuration of the industry that is possible—if we pursue policy at this point that presupposes one way or the other on that issue, and we happen to be wrong, we are going to contribute to a very substantial degree of inefficiency.

There are a few things I think that are clear. I certainly agree 100 percent with Bill Melody's comment, and I think I said the same thing myself—there is simply no reason why a financial divestiture or simply a multiple ownership situation of the common network will necessarily lead to technical inefficiencies.

We heard that same story as long ago as 1969 and earlier with respect to the "harm to the network" issue. It simply never materialized.

If anything, technology has now advanced to the point where the implementation of standards for interfacing can be done more easily and more enforceably than ever before.

There is simply no justification for the view that multiple ownership would produce physical inefficiencies of integration. I think that is a policy that can be pursued.

If nothing else, what has come out of this discussion is a recognition of the importance of pursuing the present antitrust case to try to resolve some of these very issues. If that case were dropped, for example, we would lose the ability to have some better insight as to what might constitute a more efficient structure.

I would certainly hope that at the same time we did not simply split up the Bell System for the sake of splitting it up. I would not want that to happen because I do not think it necessarily leads to a more efficient industry structure.

What is clear to me is that Bell has engaged in practices and continues to engage in practices that are designed to preserve its dominant position. As long as that continues to go on we simply cannot rely on the marketplace to teach us anything about the relative efficiencies of the dominant firm and the fringe competition.

If the industry is to be instantly deregulated or even deregulated over a relatively short period of time, as long as Bell maintains that dominant position the market will simply be incapable of selecting out the efficient from the inefficient because that presumes an equality of market power, and that is clearly not the case in this industry.

Ms. **Tiffany**. Mr. Baumol?

Mr. **Baumol**. First let me say that there are various points offered by my colleagues that I could try to rebut but I have deliberately chosen not to simply because I think it would not be useful for the record. I am aware that others have done so, too. The fact that none of us has ventured into that sort of argument is not tantamount to a confession.

Ms. **Tiffany**. I think it does help to keep with the broad issues on this subject.

Mr. **Baumol**. Yes.

I want to emphasize that I have avoided arguing whether I believe there really are economies of scale and scope not because there is absence of evidence—there I must say I do disagree with Dr. Melody. The evidence is not absolutely clear cut, but I think the preponderance of evidence does indicate that there do exist these economies.

The reason I have avoided raising the evidence on that score is that I have not tried to bring this up as a justification for the existence of the Bell System. That is attributable to history, to many good decisions, many questionable decisions that were made legislatively and in the regulatory agencies, and so on.

The Bell System is large. It is a monopoly because it was created that way whether it had the economies of scale and scope or not.

The reason I am concerned with that is that if we do decide to deregulate and we do try to introduce a truly competitive process then we must not do it in such a way that precludes the consumers from benefiting from whatever economies of scale and scope happen to be available.

For that reason I do not have to prove first that they exist. All I have to say is that a rule which says such benefits cannot be passed on to consumers: A, is costly to consumers; and, B, is one good way of precluding a real competitive process and erecting in its place a sham in which you keep alive a number of dummy competitors that could not survive on their own.

I did not say that they will not survive on their own. I really believe that entry will occur, that entrants will survive, and they will prosper. I did not say that they cannot survive on their own, but what I am saying is that the legislation must not be structured in such a way that those who are capable of surviving on their own and those who are not are accorded protection so that the latter survive along with the former at the expense of consumers.

Ms. **Tiffany**. Mr. Melody?

Mr. **Melody**. I have just a short comment. I do not think anyone has suggested that.

Mr. **Baumol**. Oh, yes, they have. They never admit it explicitly. They go about it in various ways wrapped in the American flag, which makes it look as though there were something else they were advocating.

Mr. **Melody**. Prevention of anticompetitive practices is a very different thing than the prevention of allowing Bell to pursue its own efficiencies. What I am talking about and what I believe Lee Selwyn is talking about is the prevention of anticompetitive practices.

To the extent that that affects efficiency it means that prices are set below the costs so that the distribution in terms of efficiency creates inefficiency.

In theoretical terms I think we are all in agreement. The question is for this company, at this point in time, given its history: What is the problem? I know of no one who has suggested that A.T. & T. be prevented from passing its efficiencies on to customers but that they be prevented from engaging in anticompetitive practices.

Ms. TIFFANY. Mr. Selwyn?

Mr. SELWYN. I realize this has to stop at some point, so I will be very brief.

Ms. TIFFANY. Yes, it does.

Mr. SELWYN. I just want to reiterate: I certainly have never advocated—and I think the testimony I have given before numerous State utility commissions demonstrates that—that technical efficiencies that exist be broken down or dissolved in some way that works to the disadvantage of consumers.

I think it is very important that technical efficiencies be preserved and built upon, which is one of the reasons that I also do not favor any arbitrary divestiture of portions of the Bell System simply for the sake of such divestiture.

I think divestiture does have to occur, if it is going to occur, along lines that will retain economies of scale and scope to the extent that they exist; but I think that one cannot operate on the assumption that in a market characterized by one dominant firm and a number of fringe competitors—and if I am hearing Professor Baumol incorrectly then I certainly must apologize—merely because that firm is dominant that firm is most efficient.

Unfortunately, because of the headstart sanctioned by the Government policy that created Bell as a monopoly it is simply not possible at this point to rely on the mere fact that Bell retains its dominance to somehow prove that it retains the maximum level of efficiency.

That is essentially the extent of my view on this, and I would certainly not impose, and have actually opposed, the imposition of arbitrary loadings of overheards or other fully distributed types of cost methods for the purpose of concealing true incremental costs.

I think the key here is very simple. We just do not have enough information about why the dominant firm is the dominant firm and as to whether or not we can conclude that it is the most efficient method of providing telecommunications services. I think there is evidence to the effect that at least in many areas—and by no means in all of them—it is clearly not.

Ms. TIFFANY. Thank you.

Professor Baumol, can you answer that quickly?

Mr. BAUMOL. I have one last comment and—I promise—absolutely no more. That is on one other issue that has come up repeatedly and on which I have not commented before.

If one has financial divestiture it is true that one needs not get technical separation in the literal sense that each separate firm will have to have its own plant and its own equipment, but that does not mean that financial separation can be denied all responsibility for loss of economies of scope.

Specifically, I would forecast that if you were to get real financial separation the Bell Laboratories as we see them today would either disappear or would emerge as an entirely different sort of institution.

I think good reasons can be shown why it takes an integrated system to be able to afford the sort of basic research that the Bell Laboratories provide and that are provided by very few other private enterprises in the United States.

I think that is something which illustrates what may be lost even though one continues to have technical integration after financial separation takes place.

I will not answer your comment.

Mr. **Melody**. I decided I would not say anything until I heard this. I have just one sentence: Bell Laboratories does not require technical integration; it requires money.

Mr. **Baumol**. Right. But who will supply it after divestiture?

Ms. **Tiffany**. Mr. Schwartz, did you have any more questions?

Mr. **Schwartz**. No, thank you.

Ms. **Tiffany**. Thank you very much, gentlemen. I think this has been a very useful discussion. I certainly have learned a lot from it.

Thank you, in particular, Mr. Baumol, for staying beyond your scheduled departure.

Mr. **Baumol**. You are welcome.

Ms. **Tiffany**. This hearing will now be recessed until 2:30 this afternoon.

[Whereupon, at 1:25 p.m., the hearing was recessed, to reconvene at 2:30 p.m.]

[The prepared statements follow:]

Statement of

DR. LEE L. SELWYN

President, Economics and Technology, Inc.

Mr. Chairman and members of the Committee, my name is Lee L. Selwyn. I am President of Economics and Technology, Inc., Boston, Massachusetts. Since receiving my Ph.D. from the Alfred P. Sloan School of Management at the Massachusetts Institute of Technology, I have spent twelve years in the field of telecommunications regulation, economics and policy. I have served as a consultant to the Office of Telecommunications Policy, Executive Office of the President, the Federal Communications Commission, and several state regulatory agencies. I have testified as an expert on rate design and service cost analysis in telecommunications regulatory proceedings on behalf of user groups including businesses, state governments, universities and hospitals, in some thirty state jurisdictions and before the Federal Communications Commission.

I am pleased to have been invited here to testify concerning this Committee's interest in developing more effective competitive conditions in the telecommunications industry. Stimulating competition in the industry is a necessary precondition for the success of any effort to partly deregulate the provision of telecommunications services in the way that Congress has already removed regulatory constraints from the air and surface transportation industries. Telecommunications differs markedly from the various transportation industries because AT&T so heavily dominates as the largest supplier in virtually every market area covered by traditional definitions of the telecommunications industry. In virtually every market in which AT&T participates, it enjoys a market share in excess of 70, 80 or even 90 percent. By contrast, the largest U. S. airline accounts for something less than 20 percent of total airline industry sales. AT&T's dominance of this industry developed specifically under the aegis of, indeed, as a direct consequence of, government policies that for years encouraged the growth of a single telecommunications supplier. Hence, the task now before Congress must be viewed as constituting a stark reversal of government policy which has existed in this area for most of the twentieth century.

In recent years, the changes in federal government policy toward the telecommunications industry have focused primarily upon two reasonably distinct areas: (1) the policy of the Federal Communications Commission to open telecommunications to new market entrants, and (2) the efforts of the Justice Department to require a partial divestiture of some AT&T subsidiaries. These activities concern two different types of economic remedies, one relating to the structure of the industry and the other relating to the structure of its dominant member. The bill now actively being considered in the Senate, S. 898, attempts to deal with both types of remedies.

In my opinion, the governmental policy debate, now going on in each of the sectors which are concerned with these economic remedies, has not attempted to sufficiently analyze the effectiveness of the various solutions being proposed. The success of any effort to increase competition in the telecommunications industry must be evaluated in terms of the effects upon AT&T's market power, but such analyses are not widely available. Analyses that address market power, as opposed to those which only report spot changes in annual market shares or other superficial indecies, are quite revealing. We recently completed an analysis of AT&T's current and near term market power in the supply of telecommunications terminal equipment, which we undertook at the request of Congressman Wirth's Subcommittee in the House of Representatives. We analyzed the dominant supplier's power in the terminal equipment market, utilizing economic concepts that might be applied for antitrust purposes, and measured AT&T's power in the market in terms of its ability to price terminal equipment above the incremental cost it actually incurs in providing the equipment to its customers.

AT&T's power over the telecommunications terminal equipment market arises from its existing 80%-plus market share, from the relative inability of its competitors to satisfy the demand presented to them, and from the Bell System's unique position as 100% owner of the massive installed base of in-place terminal equipment, making it uniquely able to reprice equipment originally furnished to its customers some time in the past. Even in the absence of formal price deregulation, AT&T has sought rate levels and "flexible pricing" authority from state regulatory bodies which highlight the dominant firm's pricing and marketing plans absent such regulatory agencies. By resisting efforts to alter its long-standing "rent only" policy, AT&T is able to sustain the captive relationships it created with its customers during its monopoly and near-monopoly past into its "competitive" future. The Bell System Installed Base Migration Strategy demonstrates the nature and extent of AT&T's market power, seeking to force customers of older equipment to replace it with new hardware through upward repricing of the old, in the face of widespread market resistance. The Massachusetts Department of Public Utilities specifically rejected Bell's proposed migration pricing policies in its ruling in the recent New England Telephone rate case:

> Stated another way, because the Company was unable to woo customers from the older terminal equipment to its newer products on a voluntary basis, it now proposed to achieve that result through the more coercive route of price increases on the older equipment. The Company's "migration" terminology might better be called forced emigration. [DPU 411 Decision, April 3, 1981, mimeo, p. 56]

Such a strategy would be impossible unless the current competitive capacity was constrained. Bell's price increases of 50% to 200% on the older equipment are designed to encourage users to discontinue their present service. To be sure, some customers will turn to non-Bell suppliers rather than accept another Bell service, but because of Bell's significant market power, any "losses" of sales to competitors will necessarily be limited by the collective capacity of non-Bell suppliers to meet the demand, capacity which cannot possibly respond rapidly enough to the demand stimulated by Migration-oriented pricing policies. The Migration Strategy thus attempts to manipulate normal market forces by manipulating price relationships among alternative products. In a competitive market (i.e., one in which no single firm exercised substantial market power), such pricing manipulations by one firm would not be possible.

The conclusion of our market power analysis, briefly stated, was that AT&T presently has the level of market power necessary to permit it to impose substantial price margins - of more than 200% - over incremental costs and that it will continue to maintain such margins through at least the mid-1980s. In reaching this conclusion, we relied extensively upon AT&T data provided to state regulatory authorities in the course of a number of rate proceedings. Our findings thus confirm that the sector of the telecommunications market which many consider to be among the most competitive at this time - terminal equipment - will remain under AT&T's dominant market power for a number of years, especially in a deregulated industry environment. Competition thus cannot be relied upon to provide the economic constraints on AT&T price levels which have, up to now, been imposed by price regulation. If deregulation of AT&T enables it to exercise its enormous market power to the fullest, this "remedy" will only serve to create a less competitive industry environment both for customers and competing suppliers - precisely the opposite of the desired policy goal. An analysis of this type must precede discussion of the effectiveness of any remedy that is directed either at the overall industry structure or at the structure of AT&T.

The efforts now underway to impose judicial antitrust remedies upon AT&T may also suffer from an absence of analysis of the effect of the proposed remedies. Divestiture of a major component of AT&T's consolidated corporate structure, such as the Western Electric Company or the Long Lines Department, might in fact improve the competitiveness of the industry, or it might create an independent supplier of telecommunications goods and services that would hold undue market power in its own right. The focus of the Justice Department suit appears to fall almost exclusively on the question of whether AT&T's conduct has constituted a violation of the antitrust statutes, not whether the solutions provided in those laws can be suitably tailored to the problem.

In this environment, an appealing argument can be made that Congress has the obligation to create competitive and structural conditions in the telecommunications industry that uniquely relate the special circumstances of the industry and its dominant member. As I said, S. 898 attempts to address both the competitive and structural requirements, but it does so inadequately in its present formulation. It presumes that competition is sufficient today to foster the deregulation of most telecommunications services offered by AT&T within about two years, and it seeks to impose a structure of "Fully Separated Affiliates" (FSAs) within the AT&T corporate structure.

The provisions of S. 898 do not impose significant additional structural requirements upon AT&T. As a consequence, the legislative scheme contemplated by that bill places an especially heavy reliance upon the use of cost accounting techniques to disclose and evaluate intracorporate transfers within the AT&T corporate organization. The utility of this remedy is open to substantial questions. Additionally, the legislative provisions place an unusually and inappropriately short deadline on the Federal Communications Commission to (a) approve the cost accounting system that AT&T will use [section 220(a)(2)], (b) approve the corporate structural changes that will bring AT&T into compliance with the bill [227] and (c) approve the interim process under which AT&T is allowed to operate until its final corporate structure is achieved six years after enactment. The FCC is given only 180 days to evaluate and approve AT&T's compliance with the restructuring provisions and one year to prescribe a cost accounting system. This is an extremely short time for the FCC to act on these matters, particularly when one considers that the Commission has been evaluating changes in the present accounting structure for nearly three years without reaching any conclusions and that the FCC's powers to revisit these determinations at a later time is either very limited or foreclosed by the bill's terms.

Much of the AT&T corporate organization that purportedly would be affected by the bill already appears to satisfy most of its requirements. The Western Electric Company, for example, appears to now satisfy most, if not all, of the literal requirements established for a Fully Separated Affiliate under section 227(a) of the bill. The current structure of the Bell Telephone Laboratories also appears generally to qualify as a "Fully Separated Affiliate," because there are no legislative requirements that foreclose the existing joint ownership of Bell Labs equity by Western Electric and AT&T. Section 227 (a)(5) and portions of Section 228 require that unregulated activities of AT&T be structured within one or more Fully Separated Affiliates. Thus, from a structural standpoint, AT&T seems to be required only to separate certain marketing, maintenance and operational activities associated with the provision of unregulated services into another "Fully Separated Affiliate."

The bill contains several provisions concerning the joint ownership of property between AT&T and its Fully Separated Affiliates as well as requirements for so-called arms-length economic and information transfers between the corporate entities. However, these requirements are subject to various implicit or explicit exemptions. First, the requirement that dealings with non-affiliates of AT&T be conducted on the same terms as transactions between affiliates does not apply to "any person who owns or controls a dominant regulated carrier" under section 227(c). The person who maintains this ownership and control is permitted to maintain common management personnel for dominant regulated carriers, regulated carriers and fully separated affiliates, under section 202(d), subject to the accounting test that costs attributable to the common management function are appropriately allocated. Under these provisions, the primary management of the AT&T organization can continue to operate over both the operating units that constitute the dominant regulated carrier and the FSAs, fundamentally in the manner of a holding company. The structural requirements also do not apply to property held for, and economic transfers concerning, the provision of international telecommunications and other offshore businesses engaged in by AT&T or one of its subsidiary units.

Sections 214(g) and 227(f), read together, control the flow of information between the AT&T entities. Although there is control over information that arises in the regulated sector of the AT&T business and is then transferred to unregulated operations, no controls exist over information transfers between Fully Separated Affiliates or from these FSAs to a dominant regulated carrier. The importance of this exemption can be seen today in the context of AT&T's Installed Base Migration Strategy for certain terminal equipment services. AT&T's planning documents for this marketing effort show that part of the strategy involves advance information, transmitted to Western Electric from AT&T terminal equipment market managers, concerning the number of units of new equipment that Western Electric should produce in order to fulfill new customer orders expected to be generated by large price increases on older equipment. Information regarding Western Electric's own productive capacity is transmitted to the operating companies, whose pricing decisions are in turn to achieve the appropriate level of "churn" consistent with the manufacturing affiliate's ability to deliver. Clearly, this type of advance information is valuable because it allows AT&T to more promptly satisfy the demand which it has artificially stimulated and more specifically, in terms of the precise configuration of the terminal equipment to be displaced by the Migration Strategy. Advance information transfers of this type would continue under the proposed bill, because the information arises in one FSA, the marketing subsidiary, and is transferred to another, Western Electric, or vice versa.

Even though the structural requirements imposed upon AT&T by the bill are limited, several other practices would be allowed that are neither covered by the restructuring provisions nor influenced in any respect by the cost accounting system. Even the most rigorous cost accounting standards would not affect such practices. One should assume that AT&T will choose to engage in any practices consistent with its overall corporate goals of sound management and profit maximization. These underlying incentives certainly cannot be altered by any terms of any deregulatory legislation.

The fundamental role of the person owning and controlling the dominant regulated carrier as well as the fully separated affiliates is to allocate resources among the various enterprises undertaken by the organization. This is as true for AT&T as it is for any other entity which is structured in this manner. Within the organization contemplated by S. 898, these allocation decisions will inevitably channel resources according to AT&T's overall corporate interests, not the separate interests of various affiliate organizations. Nothing in this scheme as it presently exists will prevent higher technology, more efficient resources from being allocated to the competitive affiliates, or prevent the costs of training new, inexperienced personnel to be absorbed within the regulated service organizations followed by transfers of the trained personnel to unregulated activities. Cost accounting may, I stress may, be able to identify the value of such resource allocations but cost accounting cannot alter the policy decisions that cause the allocations to be undertaken in the first place.

More important, the bill does not affect the financial consolidation of AT&T for purposes of raising capital or paying taxes. The common financial undertakings that AT&T would be allowed constitute an important source of potential cross-subsidy that is unaffected by any kind of cost accounting rules. Within the structure of AT&T's general corporate incentives, therefore, the Company can be expected to utilize its overall resources to obtain capital for its affiliates at highly favorable terms. Should all or part of the operations of an affiliate - whether fully separated or not - operate at an annual loss, the consolidation of AT&T's federal tax payments will allow the Company to offset such losses against income derived from other regulated or unregulated lines of business.

The effect of financial consolidation on AT&T's market power and growth of competition in the telecommunications industry has not been sufficiently considered. The possibility for cross-subsidization in the telecommunications industry has attracted growing attention over the past decade, as the FCC sought to introduce competition into selected sectors of the industry, thereby creating the possibility that a telecommunications firm, engaged both in monopoly and competitive activities, might use its monopoly position in the former to cross-subsidize, and hence enhance, its competitive position in the latter, at the expense of its captive monopoly service customers.

In general, economic cross-subsidization of one activity by another may be said to exist if (a) the cost of the subsidized activity is less than it would otherwise be were the firm not also involved in the subsidizing activity, or (b) the cost of the subsidizing activity is higher than it would otherwise be were the firm not simultaneously engaged in the subsidized activity. If condition (a) exists by itself, one could conclude that some economy or other benefit of integration of the two activities exists, thereby making it possible for the firm to engage in the subsidized activity without adversely affecting other activities or their consumers. The existence of condition (b) implies that condition (a) also exists, for if it did not, the firm would be experiencing a diseconomy of integration indicating that total divestiture of one of the two activities would be economically prudent. In such circumstances, the customers of the subsidizing service would be better off if the firm did not engage in the subsidized activity.

Traditional tests for economic cross-subsidization among existing common carriers have concentrated on issues of cost allocation and return on investment. These sometimes involve the establishment of different target rates of return on different classes of service, ostensibly to reflect differences in risk between monopoly and so-called competitive services. Such accounting-oriented tests are appropriate where the various services involve the use of common facilities or personnel organizations. Where the various services are to be furnished by separate corporate organizations - such as Fully Separated Affiliates - involving separate plant and organizational support, the cost accounting tests become relatively meaningless. The proper, alternative approach is to assess the financial impact which the FSA will have on the overall corporation, in terms of its debt/equity structure and investor perceptions of risk, and their consequences for the overall cost of capital to the firm as a whole.

The issue of whether Congressional legislation in the telecommunications area can appropriately stimulate competition and serve as a replacement for judicially-imposed antitrust remedies has not been adequately resolved. It might be possible for Congress to attempt to impose additional restraints on AT&T's intracorporate behavior to assure that these goals are satisfied. However, as I indicated, as long as AT&T's corporate affiliates fall within a common organization, additional provisions that attempt to influence this behavior likely will not succeed in displacing the overall resource allocation functions of the corporate parent and will not remove the incentive to operate in a profit maximizing manner. This, in turn, might suggest that full divestiture of some AT&T units is the most viable solution but, again, the market power of totally divested units might be so substantial as to render illusory any benefits from this course of action.

There are, however, three courses of action that ought to be considered in order to strengthen the Congressional goals in this area. First, rather than merely attempting to further define AT&T's internal corporate behavior, policies should be designed to increase public ownership of some separated affiliates, to require separate, nonconsolidated financing of their activities and to have unregulated activities bear the financial and tax consequences of the separated businesses. AT&T would still effectively control the entities and would still be subject to the restraints on behavior already proposed in existing bills, but additional provisions would require the unregulated entities to stand on their own in a financial as well as cost accounting sense.

Second, the legislative provisions that continue to rely upon cost accounting could be strengthened by requiring more time and oversight concerning the accounting system that would govern so much of the controls on AT&T's internal behavior. Congress could consider creating an interim Accounting Principles Board to evaluate the system that AT&T is now devising, and to modify the system after experience has demonstrated where it needs to be modified. One year is simply not enough time to evaluate such a complex subject, nor is it likely to reveal deficiencies in the actual operation of the system. Railroad deregulation laws enacted by the last Congress provided for such a transitional accounting board [49 USC 11161] and there is firm precedent for this type of remedy.

Finally, as I mentioned at the outset, the legislation as it now exists presumes that competition in most markets is sufficient to allow relatively quick deregulation. The legislation would be a better substitute for antitrust enforcement if it required the existence of price competition to be affirmatively demonstrated by the proponent of deregulation in a given segment of the industry. The effort to stimulate competition is somewhat divorced from the need to resolve antitrust-related questions in the legislation. A bill could be passed which addressed either of these two requirements without necessarily addressing the other. However, since the thrust of the legislative effort is to address both concerns, the antitrust-related issues could be addressed with more confidence by the Congress if it assured itself that a system of regulation would be preserved until competition were firmly in place.

STATEMENT OF DR. WILLIAM H. MELODY*

Mr. Chairman, I am pleased to have this opportunity to appear before the Committee to discuss the antitrust aspects of S 898, the "Telecommunications Competition Deregulation Act of 1981." Unfortunately, in its present form, S 898 is not likely to achieve its stated objective of increased competition in the telecommunications industry, and in fact there is a greater probability that it will have precisely the opposite effect.

The fundamental purpose of economic regulation in the telecommunications and other public utility industries is to provide a substitute for effective market competition in limiting and constraining the monopoly power of a dominant firm. The constraints of regulation are intended not only to protect consumers of monopoly services but also to prevent that monopoly power from being extended to spoil existing and new markets that could and should be competitive. S 898 releases AT&T from certain existing constraints provided under federal and state regulation and the 1956 Consent Decree, but does not have adequate regulatory or antitrust protections to prevent AT&T from using its vast monopoly power to spoil the possibility of effective competition in the potentially vast enhanced communication equipment and services market that is the evolving point of convergence of several industries ranging from computers to newspapers.

Deregulation that removes government restrictions on effective competition is sound economic principle. An increase in effective competition will lead to increased efficiency, a

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more rapid implementation of the benefits of new services and technologies and lower consumer prices than would otherwise prevail. If regulation is restricting effective competition rather than monopoly practices, then it is restricting economic efficiency. The lifting of regulatory restrictions in airlines, trucking and securities revealed industries that were already competitively structured. No firm dominated any segment of these industries, let alone the entire industry as well as the essential building block facilities for other entire industries. For example, United Airlines, the largest airline provides less than 20% of the intercity airline market and a signficantly lower share of the intercity transportation market. It has no role in airport terminals, local transportation systems or airplane manufacturing.

Where a dominant firm has overwhelming monopoly power, such as AT&T, deregulation of the dominant firm will bring about economic inefficiency, not efficiency. Deregulation will simply permit the dominant firm to extend its monopoly power to related markets and industries, thereby spoiling what would otherwise be competitively efficient markets. The incentive to to do so is especially compelling in telecommunications where changing demand and technology have opened many avenues for potential competition that have yet to be travelled because entry to them is controlled by AT&T. The straightforward economic solution to this problem is to restructure the industry by requiring the dominant monopoly to divest portions of its vast enterprise. Then the precondition for effective deregulation will have been met.

If the monopoly power of the dominant firm is so great that divestiture is not possible, then deregulation will not, by itself, bring an increase in effective competition. In fact, the removal of existing regulatory constraints will have to be replaced by other regulations, and an increased responsibility for protecting against monopoly practices will be shifted to the antitrust area. S 898 does, in fact, replace one set of regulatory constraints with another, but it does not provide the necessary strengthening of the role of antitrust.

S 898 provides for the establishment of separate subsidiaries by AT&T for its participation in potentially competitive enhanced telecommunication service. These subsidiaries would not be subject to regulation. Thus, whereas the existing interface between AT&T's monopoly and potentially competitive services takes place under a regulatory scheme that encompasses both kinds of services, under S 898 that interface will take place between regulated monopoly and unregulated potentially competitive services. The unregulated, potentially competitive services that are now dominated by AT&T and that depend upon essential facilities over which AT&T has a regulated monopoly will now fall solely within the province of the antitrust laws. The antitrust laws are now expected to constrain AT&T's monopoly practices to a degree that AT&T will accept substantial inroads into its dominant market share by firms supplying competitive services that require reasonable access to essential local facilities over which AT&T has a monopoly. If substantial inroads are not made by AT&T's competitors, then these newly unregulated markets will remain monopolized. Thus, the transition to unregulated, competitive markets will require a very high level of visibility, and perceived effectiveness by AT&T, of the antitrust laws.

S 898 also presumes that FCC regulation of the interface between regulated monopoly and unregulated potentially competitive services will be more effective in preventing interservice subsidies than FCC cross-subsidy regulation in the past. As has been well documented, the FCC's twenty year attempt to implement effective accounting and cost controls of AT&T in order to prevent cross-subsidy has been a dismal failure. There is no indication that the FCC will be any more capable of preventing AT&T from engaging in the subsidy of its competitive services by its monopoly services under the new separate subsidiary approach. In both instances, what is necessary is a revision of the accounting and reporting system that is applied to AT&T's services. The FCC's attempt to establish such an accounting and reporting system by revising the Uniform System of Accounts has been deactivated. Clearly, there is no hope for effective regulation over cross-subsidy unless a revised accounting and reporting sytem is implemented in advance of, or at least simultaneously with the new legislation. The legislation should require implementation of a revised Uniform System of Accounts by the FCC at the same date AT&T establishes its unregulated subsidiaries. Of course, the establishment and effective implementation of the essential revised accounting and reporting system will require additional resources for the FCC, and that should be provided in the bill. We must not forget that AT&T has many separate subsidiaries now, and existing regulation does a very ineffective job at reviewing the reasonableness of transactions among them.

Effective implementation of the separate subsidiary requirement will require that existing subsidiaries be reorganized along functional lines, rather than simply creating additional new subsidiaries. Most significant among these is a clear separation between local and long distance facilities and services into separate subsidiaries. The bill should require such a separation, and should direct the FCC to hold hearings and develop a restructuring plan that will simplify the requirements for both federal and state regulation.

The intent of S 898 is to create market conditions that will lead to the development of competition in the markets that are being deregulated. If competition is to develop, all competitors must have equal access to local exchanges under reasonable terms. To ensure this, the bill should specify that at the time of implementation, all AT&T local companies will establish a uniform set of access services and charges that are equally available to all competitive firms, including AT&T's restructured intercity carrier subsidiary.

In keeping with the objective of creating effective competition in unregulated markets, the bill should more strongly assert this objective. It should direct both the FCC and the Department of Justice's Antitrust Division to monitor competitive developments in these unregulated markets and require that annual reports be submitted to Congress assessing the progress that has been made toward the establishment of effectively competitive market conditions. The Department of Justice should be given a mandate to give this industry special attention and to be especially vigorous in pursuing antitrust violations. In this regard, the bill might state that the current Justice antitrust suit against AT&T is entirely consistent with the objective of the bill, but simply reflects pursuit of a different path to effective competition that should be considered by the Court on its merits. Finally, the bill should specificially provide that in the event of future antitrust violations by AT&T that are established in private antitrust suits, the Courts should consider structural relief through divestiture.

It is clear that if the objective of S 898 to establish unregulated competitive markets in certain telecommunications service and enhanced service markets is to be implemented effectively, the strengthening of regulatory provisions and the specification of an expanded role for antitrust are essential. I recommend to the Committee that such changes be made to S 898 before final adoption.

Deregulation, Cross Subsidy and the Public Interest

Testimony of William J. Baumol
before the Senate Judiciary Committee
July 24, 1981

My name is William J. Baumol. I am professor of Economics at Princeton and New York Universities and President of The American Economic Association. However, I alone am, of course, responsible for the views expressed here today, which are based on economic analysis and more than 20 years of association with regulatory processes in the United States.

I am deeply grateful for the opportunity to appear before this eminent body today, at this crucial point in the history of the telecommunications industry. The decisions taken in this arena in the next few months are likely to have profound consequences not just for this industry, but for the entire economy and its ability to compete in the markets of the world.

My testimony today will focus on the issue of cross subsidy. But in addressing this subject my comments may also prove relevant to some of the other major areas with which the committee is concerned -- the role of economies of scope, entry and entry barriers and the appropriate role of the regulatory agencies.

I will make three central points: First, that the issue of cross subsidy is raised by those whose main concern is certain prices shall not be too low.

But, in the last analysis, the prevention of low prices serves primarily the interests of competitors who are unable to compete effectively without some sort of protective umbrella. Consumer interests are ultimately served not by the prevention of low prices, but by their encouragement.

Second, I will show that cross subsidy is not a vague and ill defined phenomenon. There exist well defined criteria which are those called for by the public interest and which can serve as effective instruments for the antitrust authorities.

Finally, I will point out that if areas of the telecommunications industry are to be deregulated, and opened up to free entry, a development which is potentially highly desirable, it is essential that this be accompanied by elimination of unjustifiable restrictions upon freedom in pricing decisions both by entering and incumbent firms. For otherwise, the new regime, which will masquerade as one of competition, will prove to be no more than a governmentally protected cartel. It will serve the interests of those entrants who are too inefficient to compete on their own merits, but it will do so at the expense of the consumer and it will serve to reduce the efficiency of the industry and the economy generally.

On the Issue of Cross Subsidy

In regulatory arenas the debate over issues of cross subsidy has raged for just about a century. In every episode in this debate the position of each participant has been strikingly predictable. Particularly when the industry contained one or more large and successful firms, entrants could be relied upon to inscribe the issue on their banners, arguing that the incumbent was willing and able to compete unfairly by charging indefensibly low prices for competitive services, making up for any resulting deficit by high prices for services not subject to competitive pressures. The incumbents could, of course, be expected to argue that they neither had acted in such a manner in the past nor were likely to do so in the future.

The point in all this is that the issue of cross subsidy turns on the notion that the price of a service offered by a large incumbent in the competitive arena may conceivably be too low, and thus can constitute an unjustifiable impediment to entry. But there is also the other side of the coin. The entrants' interest are served by forcing the incumbent to charge as high a price as they can manage to impose upon it, for high prices by the incumbent relieve an entrant from any requirement of efficiency in its own operations and permit it to obtain high profits earned not by virtue of superior quality or lower costs but with the help of the protective price umbrella it has managed to erect.

Thus, while the issue of cross subsidy is a valid one, and the need for vigilance against the use of unacceptably low prices as an instrument of unfair competition is difficult to dispute, one must never lose sight of the opposite danger. Almost without exception, entrants and potential entrants, arguing the need for measures to prevent cross subsidy have sought to impose pricing criteria which economists have rejected with virtually one voice, exposing them as protectionist instruments with no justification in economic analysis.

For as economists beginning with Adam Smith have emphasized, in the last analysis the interests of consumers are served by the adoption of prices which are low, not by the imposition of prices that are high. The competitive process is extolled by economists not as an end in itself but because of the benefits it offers consumers, not the least of which is the market pressure that keeps prices low.

One must, therefore, beware of entrants and potential entrants who are not sure of their ability to compete and who consequently seek to impose upon an industry a set of rules and a system of controls designed to impede the pressures of competition, to force high prices upon incumbents and to prevent them from responding competitively in other ways.

The immediate issue, then, is to determine whether there exist administrative instruments and operational criteria capable of preventing cross subsidy without undermining the competitive process. The objective is to prevent prices from being too low without forcing them artificially to be too high. In the next section of my testimony I will show that there do exist operational criteria which can serve the purpose adequately. Then, in the last section I will discuss the choice between antitrust and regulation as the means to enforce those criteria.

But before turning to these matters I should like to deal with one source of confusion that has beset the debates on our subject -- the relation of economies of scope to criteria of appropriate pricing.

The very issue of cross subsidy implies that the firm whose behavior is in question must be the producer of a multiplicity of different services, as is true of most firms in the economy. Normally, the reason a firm supplies a variety of different products is that there is complementarity in their production -- that it is cheaper to have one firm produce both services A and B than for these two items to be produced in isolation by more specialized enterprises. Such economies of scope mean that if an incumbent firm is the supplier of a large multiplicity of services, while an entrant happens to supply only a few, the incumbent will have a cost advantage which may conceivably be quite substantial.

The point of all this is that it is entirely appropriate and proper for the benefits of such economies to be passed on to consumers in the form lower prices. This may make life harder for the incumbent but that is only a manifestation of lack of efficiency. This relative inefficiency is attributable, it is true, not to incompetence but to inability to offer economies of scope comparable to the incumbent's. Nevertheless, these cost differences are real, and there is absolutely no rational ground for depriving consumers of the corresponding price advantages. The market mechanism's vaunted accomplishments are attributable in large part to the fact that it makes absolutely no concessions for inefficiency, whether attributable to incompetence or any other source.

On Criteria of Cross Subsidy

To determine whether a particular price involves a cross subsidy, that is, whether it is unjustifiably low, it is necessary to have a criterion which is acceptable on logical grounds and operational in practice. This is not the place to review on any detail the very substantial literature devoted to the subject or to examine the technicalities of the relevant criteria. Rather, my objective here is merely to confirm that such criteria are available, thus showing that we are not dealing with an uncharted area in which drastic government intervention, is required to prevent the consequences stemming from the absence of the required standards and information. The available criteria of cross subsidy are consistent with the tenets of economic analysis, they have been advocated by legal scholars and have perceive the approbation of a number of courts, which have used them in deciding a variety of antitrust cases in recent years.

The basic criterion to which I refer is that associated with the work of Professors Areeda and Turner of The Harvard Law School, though the approach has a long prior history in the writings of economics. Basically, the Areeda-Turner criterion asserts that the price of a good or a service sold to a customer never involves a cross subsidy if the price covers all of the costs caused by the act of providing that item to the consumer. In other words, if as a result of supplying that service to the consumer the company's total outlays are increased by, say, $12 over what they would have been otherwise, then any price for that service which is at least equal to $12 must be compensatory, and its customers, therefore, cannot reasonably be deemed to be the recipients of any cross subsidy.

In the jargon of economists, then, the Areeda-Turner criterion holds that no price for a service which exceeds the marginal cost of that service involves any cross subsidy. The logic of the underlying analysis is clear enough. It should be equally clear that any administrative process or any alternative criterion which systematically requires prices to be higher than this constitutes precisely the sort of protective umbrella which will serve the interests of inefficient competitors but those of no one else, least of all those of the affected consumers. It is important to keep in mind that, throughout the history of the cross subsidy issue, entrants have agressively pushed for prices higher than those required by the Areeda-Turner criterion and for criteria far less defensible in terms of the interests of consumers.

The few paragraphs that have been devoted here to discussion of the Areeda-Turner criterion have, of course, deliberately abstracted from the details of its implementation and have not dealt with a variety of important subsidiary issues which accompany the standard. For example, recognizing that firms do not normally keep accounts reporting their marginal costs, Areeda and Turner have suggested that average variable cost can in practice usually serve an an acceptible proxy for marginal costs.

Naturally, since the courts are concerned with practical issues, it is this form of the Areeda-Turner criterion, expressed in terms of average variable cost, which has generally made its appearance in legal decisions.

Thus, recognizing that there is a good deal more to be said about the subject, there are nevertheless several conclusions that can be drawn:

a) A criterion of cross subsidy proposed by legal scholars and resting upon the precepts of economic analysis is available and its ramifications have been thoroughly explored;

b) The use of the criterion in a series of court decisions demonstrates its workability;

c) Attempts by entrants and potential entrants to substitute regulatory processes and artificial tests of cross subsidy which systematically lead to the imposition of higher prices upon incumbents must be recognized for what they are -- as efforts to erect an umbrella which protects themselves from the rigors of true competition. Their proposals are generally sanctioned neither by economic analysis nor the elementary logic of the issue.

Implications for Deregulation in Telecommunications

All of this has clear implications for the proposals for partial deregulation of the telecommunications industry that are now under consideration. It has been proposed that AT&T be divided into two affiliated portions, one of which will continue to be subject to the regulation of the FCC and the state public utility commissions, while the other is left to the oversight of the market mechanism. Freedom of entry and competitive pressures are then to serve as substitutes for government intervention in the operation of the deregulated segment of the firm.

Such a change would have a double consequence for entry. It would remove governmentally imposed impediments to the entry of other firms into the telecommunications industry. But, at the same time, it would enable the Bell System to enter areas from which it was previously excluded.

From the point of view of the economist this is all to the good because it encourages the competitive process, expands consumer choice and serves generally to increase the efficiency of operation of the economy. But in undertaking such a step enormous care must be exercised to prevent its perversion into something which superficially resembles competition, but which is far worse than anything close either to true competition or to the previous arrangement in which the industry consisted of a single firm, a regulated monopoly enterprise.

It is perfectly understandable that entrants and potential entrants into the industry view with some distaste the prospect of competing with the Bell System. Its economies of scale and scope and its reputation for efficiency suggest that it will be no easy opponent. Accordingly, it is entirely to be expected that these entrants will do everything they can to secure the adoption of measures that prevent the incumbent firm from competing effectively. It is to be expected that they will raise the issue of cross subsidy. It is to be expected that they will advocate rules ostensibly for the prevention of cross subsidy which in fact force unjustifiably high prices upon the incumbent. It is to be expected, in fact, that they will seek either to dismember the incumbent firm, in order to deny it (and the public) the efficiency advantages of economies of scope, or that instead, they will seek to force the incumbent to continue under a regime of tight regulations from which entrants are immune. All these things are to be expected because they have always been the gambits adopted by firms which fear they will be runners up in the competitive process.

But though these proposals are understandable they are hardly acceptable. On the contrary, from the point of view of the public interest they represent a most dangerous and damaging prospect. Under the guise of preservation of competition they will offer protected havens to inefficient competitors; and in the process they will make a mockery of the competitive mechanism.

In essence, they amount to an arrangement under which consumers will be forced to pay prices higher than those that are compensatory and acceptable to the incumbent supplier. Under it, firms which are less efficient than the incumbent will nevertheless be able to capture and retain substantial segments of the market, thereby, because of their relative inefficiency, wasting resources which the economy can ill afford to forego. It will keep alive a multiplicity of firms operating in the guise of competitors. But it will do so only by preventing the exercise of competition. This is what I meant when I referred before to the creation of a governmentally imposed cartel. For that is precisely what such an arrangement amounts to, with firms, as it were, assigned their exclusive territories on which they are immune from competitive pressures.

This result is clearly worse than the old regulated monopoly because it gives up economies of scale and scope and offers shelter to enterprises regardless of the efficiency of their operation. It is clearly worse than true freedom of competition in which entrants and incumbents alike are permitted to compete fully and fairly, because such a truly competitive regime awards business to those who merit it by their efficiency.

In the circumstances now at issue, if there is to be a deregulated portion of the telecommunications industry it is essential that deregulation be extended even handedly to all the parties involved. In particular, the affected activities of the Bell System must be left to the market mechanism, only subject to the same degree of surveillance by the anti trust authorities that is extended to all unregulated firms.

In other industries the presence of one or more large firms has, with justice, not been considered good reason to subject them to regulation. The job of prevention of cross subsidy has been left to the anti trust laws and the associated principles on unacceptable pricing principles. The same reasoning is equally applicable to the deregulated portion of telecommunications. In terms of the public interest, it simply will not do to leave only the Bell System constrained by regulation, its pricing decisions inhibited at every turn by rules ostensibly designed for the prevention of cross subsidy.

Concluding Comment

The cross subsidy issue is a real one. In principle it is indeed possible for an incumbent firm to compete unfairly by adopting non compensatory prices for its competitive services. But the anti trust authorities are perfectly capable of dealing with the issue elsewhere in the economy and there are no reasons for special government intervention into telecommunications on cross subsidy grounds.

The issue is merely one focal point of the struggle to prevent true competition in telecommunications and to substitute a governmentally-enforced cartel which provides a haven for inefficient entrants. That such an arrangement will bring no benefits to consumers is obvious enough. But it should also be recognized that it will constitute yet another handicap which the US economy will have to overcome in its critical struggle to retain its place in its own markets and its share in the markets of the world.

AFTERNOON SESSION

The CHAIRMAN. The committee will come to order.

I believe we now have our last panel on this antitrust hearing: Mr. Paul H. Henson, chairman of the board and chief executive officer, United Telecommunications, Kansas City, Kans.; Mr. George Shea, Association of Data Processing Services Organizations, Atlanta, Ga.; and Mr. Edwin Spievack, North American Telephone Association, Washington, D.C.

You gentlemen may proceed with your statements.

STATEMENT OF PAUL H. HENSON, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, UNITED TELECOMMUNICATIONS, INC., KANSAS CITY, KANS.

Mr. HENSON. Thank you, Mr. Chairman.

I am Paul Henson, and I am chairman of United Telecommunications.

The CHAIRMAN. Are all of you taking the same position or a different position?

Mr. HENSON. It is yet to be determined, I think.

The CHAIRMAN. You have not talked with each other about it?

Mr. HENSON. That is correct.

I have filed a statement, sir; and I would like to just summarize and highlight that statement if I might.

The CHAIRMAN. Without objection, your entire statement will be inserted in the record after the panel discussion, and you can just highlight it.

Mr. HENSON. Thank you, sir.

We deeply appreciate this opportunity to appear today and provide our views on Senate bill 898, particularly the impact of the bill on competition in the telecommunications industry.

United is on record fully supporting S. 898. On balance, we think it is a good bill. Now that the measure has been favorably reported out of the Committee on Commerce, Science, and Transportation, we continue to urge its early enactment.

The reason for the urgency of such action is that the telecommunications industry has operated under an uncertain regulatory climate long enough. Everyone involved in this industry—providers of service, customers, and investors—needs a national telecommunications policy designed for the future and for full competition which can be relied upon with some degree of assurance. We believe S. 898 provides that needed certainty.

On the other hand, we do not view S. 898 as the final answer to all of the industry's problems. Rather, we see it as an acceptable attempt to update the Nation's telecommunications policy.

We cannot expect to resolve all of the marketplace issues in advance. Those issues are going to have to be determined and settled in the marketplace.

United further believes that S. 898 makes the necessary tradeoffs which, with a few exceptions, are vital to accomplish the proper regulatory goals and which are on balance equitable to all parties concerned.

The exceptions I have in mind are exclusionary provisions which permanently prohibit regulated carriers from engaging in certain lawful business activities.

We understand the reasons and political pressures which have led to these provisions, but in the absence of some reasonable time limitation they are fundamentally anticompetitive in character. They should either be removed completely or, at a minimum, limited in duration.

United is engaged in the provision of a number of telecommunications services and products. We either are or intend to be in competition with A.T. & T. and other giants of the industry.

As an aside, United business units are members of both ADAPSO and NATA, my colleagues on the panel today.

Although we are smaller than some competitors in the telecommunications industry, we vigorously support the concept of full and fair competition.

On the other hand, we oppose in principle those who seek legislation designed to protect a specific industry from the rigors of full and fair competition. We believe it to be contrary to the public interest for Congress to adopt a national telecommunications policy designed to protect a specific segment of that industry from competition.

Unfortunately, the bill does contain provisions which in fact do protect certain industries from competition.

We continue to urge the modification of these provisions even while acknowledging that the need for legislation and the certainty it will bring to the entire industry outweigh the disadvantages inherent in such a limited exclusionary provision.

Much attention and even more rhetoric have been given to cross-subsidies, actual and possible. At least two points should be considered:

Those cross-subsidies which exist were instituted on purpose by Federal and State regulators acting in the public interest as they interpreted that public interest.

Cross-subsidies exist in nearly every business where the allocation of common overheads is necessary. Auditors and the accounting profession are accustomed to dealing with allocation problems.

Congress ought not to try to make wrongdoing impossible but only to define it and make it visible.

Some simple facts should be acknowledged. If there is any commonality between two or more enterprises common costs will have to be allocated. The costs of any one enterprise are then established partly by honest audited accounting and partly by definition—that is, the rules of allocation.

This situation is neither unique nor new. Multiproduct companies face this problem all the time, and auditors are accustomed to dealing with it. The problem is no more worthy of public or legislative concern than are the cost accounting practices of any other industry, except for one thing: The now nearly obsolete concept that one part of our business has a guaranteed profit.

While this exceptional factor will diminish rapidly with time and can be mitigated under any circumstances——

The CHAIRMAN. Excuse me just a minute. Are you reading your statement? I do not want to put it in the record twice.

Mr. HENSON. No, sir, I am not.

The CHAIRMAN. I understood you wanted to highlight it.

Mr. HENSON. Yes, sir.

The CHAIRMAN. That is fine, but I do not want you to put your whole statement in the record and then read it, too.

Mr. HENSON. No, sir. I am trying to highlight and summarize.

The CHAIRMAN. In other words, that would be a duplication for the record, and we have to pay $3.50 a page for every page that this reporter has to write.

Mr. HENSON. I am very conscious of expense control. I will do my best.

May I continue, sir?

The CHAIRMAN. Yes, sir; you may continue.

Mr. HENSON. Thank you, sir.

The bill provides for the ability to change our allocation rules. These rules can be redetermined and remove cross-subsidies as often as is necessary to be consistent with the public interest.

There are unlimited resale provisions and an obligation to do for any customer what has been done for the so-called affiliated customer or the FSA on comparable terms, and this provides the best kind of protection for the public in the absence of a wide choice among equivalent services.

The CHAIRMAN. Off the record.

[Off the record discussion.]

The CHAIRMAN. You may proceed.

Mr. HENSON. Thank you.

United submits that S. 898 does establish the requirements to maintain the FCC's and the public's scrutiny over the provision of regulated services by all carriers. Under such regulation it is seemingly impossible for A.T. & T. to engage in significant cross-subsidies for significant periods of time of a competitive service or a regulated monopoly service.

We believe the provisions to prevent cross-subsidies are adequate. We believe that telecommunications legislation is necessary to provide stability to the industry and to encourage the implementation of new and improved technology for the benefit of the served public.

We believe the bill embodies those provisions which will accomplish desired public interest goals and which will more readily assure that full and fair competition flourishes in the telecommunications industry.

Thank you.

Ms. TIFFANY. Thank you.

Mr. Shea, would you proceed with your summary?

STATEMENT OF GEORGE M. SHEA, ASSOCIATION OF DATA PROCESSING SERVICE ORGANIZATIONS, ATLANTA, GA.

Mr. SHEA. Thank you.

Good afternoon, ladies and gentlemen.

My name is George M. Shea. I am vice president, secretary, and general counsel of National Data Corp. of Atlanta, Ga., one of this country's leading remote data processing service companies. I am also a member of the board of directors of the Association of Data Processing Service Organizations. ADAPSO, as our association is more commonly known, is the principal trade association of the computer services industry.

I wish to thank the committee for this opportunity to express the views of my company and my association with regard to S. 898.

In the interests of time, I am going to depart from my prepared statement and summarize it for you.

My company and others in ADAPSO are members of a highly competitive, innovative, and thriving industry. In 1981 our annual revenues will approach $20 billion. The industry's 11,000 participants, the overwhelming majority of which are small businesses, provide the American and worldwide public with a broad spectrum of computer services. These include such diverse offerings as local batch processing, software design and development, and facilities management.

Our remote computing services enable geographically dispersed customers to access distant centralized computers for both interactive or time-sharing and batched data processing application.

The connection between the customer and the computer is achieved through the use of common carrier communications services. In other words, communications facilities are used to deliver data processing services much the same way that the mail, trucks, and other conventional means of transportation are used to deliver physical goods to customers that are geographically distant from factories and stores.

Unlike other industries, however, remote access data processors are totally dependent upon one basic means of transport to deliver our services to the public; and that is communications facilities.

As the members of this committee are well aware, the dominant provider of such service in the United States is A.T. & T. which exercises almost exclusive control over access to this country's long distance and local telephone networks.

Consequently, remote data processors such as National Data Corp. are completely dependent upon A.T. & T. in order to provide our services to the public.

In today's market in which the computer services industry stands in a customer-supplier relationship with A.T. & T. we encounter sufficient problems with respect to cost, quality, and availability of communications.

Our lack of control upon this one independent supplier is underscored by the FCC's recent decision which granted A.T. & T. increases ranging between 35 and 100 percent in services which are the lifeblood of our members—private line and WATS or wide area telephone service.

These highly inflationary increases would not be tolerated in a competitive environment but must be accepted by our members because A.T. & T. is the only game in town.

If A.T. & T. were permitted to become a competitor as well as a supplier to our industry without adequate competitive safeguards these problems would be exacerbated to the point where many of our member companies would be forced to close their doors.

In such an environment A.T. & T. would have both the incentive and the opportunity to use its monopoly power, resources, and control over the communications network of this country to destroy or at least inhibit competition.

As both a competitor and supplier of service to the computer services industry, A.T. & T. would be uniquely situated to engage in tying and other forms of unfair competition.

As the predominant provider of telecommunications service, A.T. & T. could easily misuse privileged information about the network, about its customers, and about our customers.

In the same vein, A.T. & T. could manipulate the quality, the availability, the restoration, and the maintenance of service for anticompetitive ends.

Because of its dominance and its ability to establish de facto standards, A.T. & T. could selectively structure protocols as well as other technical characteristics of communications service to favor its own data processing service offerings.

Because of its enormous monopoly sector revenues, A.T. & T. could use its Government-conferred franchise to support its competitive endeavors in unregulated markets.

This bill, ladies and gentlemen, would effectively remove the constraints of the 1956 consent decree thereby allowing A.T. & T. to enter now unregulated markets such as our industry for the first time.

Given its history of anticompetitive conduct, ADAPSO is at a loss to understand why the bill would eliminate competitive safeguards afforded by that decree without providing adequate substitutes.

In fact, we question whether there is a basis at all in law for executive or legislative vacation of a judicially imposed decree.

ADAPSO shares the view of the Justice Department that there is only one completely satisfactory way of assuring that A.T. & T.'s entry into unregulated markets is not accompanied by anticompetitive abuse. That way, the only way, is divestiture.

In lieu of a consent decree and divestiture, however, S. 898 proposes a singularly misnamed safeguard—a fully separated affiliate.

In looking through the various provisions of the bill, it seemed almost untenable for us to imagine a structure in which parent and affiliate could engage in joint ventures, share offices and property, use common facilities, and call that separate.

How can you call a financial structure in which A.T. & T. can guarantee the debts of its affiliate separate, or when you have the opportunity to transfer employees freely back and forth between parent and affiliate—can that truly be termed "separate"?—when you have the common name and common logo—the Bell logo—used by both parent and affiliate—how can that be termed "separate"?—where you have a structure in which parent and affiliate engage in joint institutional advertising—can that truly be termed "separate"?—where you have a structure in which A.T. & T. can perform critical research, development, and manufacturing for its affiliate—can that be separate?

Can any of these provisions separate A.T. & T. and its affiliate either in their eyes or in the eyes of the public? The answer is overwhelmingly no to ADAPSO and its members.

These shortcomings are made far worse by a provision in the bill that places a total straitjacket on the FCC's ability to prescribe further structural safeguards.

The bill also permits A.T. & T.'s affiliate individually to own transmission facilities, one of its worse shortcomings.

A.T. & T. could allow relevant portions of its basic network transmission offerings to deteriorate slowly or become outdated, forcing users to turn to its affiliate.

Even if A.T. & T. did not allow its network to deteriorate it could simply refuse to add new facilities. Then, because the affiliate is permitted to provide its own private line network, users would be forced to turn to the affiliate for service. The affiliate would then be able to tie its competitive services and equipment to access to the network resulting in a degradation of basic essential communications services, one of the principal objectives of the bill and one which cannot be met the way it is structured presently.

Finally, any congressional restructuring of the Bell system before the Justice Department antitrust suit against A.T. & T. is decided will compromise the litigation—it has to—by affecting the court's willingness to prescribe the relief that might otherwise be required by the facts.

While the bill would prohibit A.T. & T. from misusing valuable business information about its affiliates' competitors, which it could then put to anticompetitive ends, violations would be extremely difficult to enforce.

Unlike any of my company's competitors A.T. & T. is in the unique position of not only having a list of my customers but also an intimate knowledge of the services which I provide to them. Only divestiture of A.T. & T. affiliates will eliminate this problem.

One way in which the potential for other anticompetitive abuses could be lessened would be to require outside minority or majority ownership of A.T. & T.'s separated affiliate. The affiliate should have a sufficient number of stockholders to comply with the SEC reporting requirements applicable to publicly held corporations.

In this regard ADAPSO actively supported the amendment offered last week by Senator Hollings which would have required minority ownership of the affiliate. The amendment lost by only one vote, indicating substantial support for this position.

Furthermore, to guard against anticompetitive financing by A.T. & T. once the affiliate is fully established additional capital should be required to be obtained only through independent financing.

Additionally, the affiliate should be required to pay back over a period of time all initial capital which A.T. & T. advances to it.

In closing, ladies and gentlemen, I wish to stress that neither ADAPSO nor any of its members is unalterably opposed to A.T. & T.'s entry into our industry. We ask only that A.T. & T. be required to compete fairly and that it be restrained from using its regulated monopoly power and resources and its control over the communications network, which is so essential to all of us, for anticompetitive ends.

It is therefore the view of ADAPSO and its members that S. 898 should not be enacted unless it is substantially modified to prevent the separate affiliate from owning transmission facilities, engaging in joint ventures in partnerships with its parent, jointly using property and facilities, and benefiting from the parent's marketing or applied research efforts.

Any policy established by this Congress in the area of telecommunications needs to incorporate and must incorporate the principles of free market enterprise. Yet deregulating a monopolist in markets in which little or no competition exists may in fact deter a competitive goal and adversely affect basic telecommunications service.

Furthermore, revoking the conditions of the 1956 consent decree and allowing A.T. & T. to enter unregulated markets such as the data processing services industry creates an enormous potential for unfair competitive abuse.

It is essential that A.T. & T.'s entry into these markets be accompanied by adequate safeguards to insure continued competitive growth and to foster continued productivity.

For all these compelling reasons this committee with its special expertise in antitrust matters must closely examine this legislation. Too much is at stake to allow the bill to reach the Senate floor without improving its anticompetitive provisions. My company, my trade association, and I are willing to work closely with you and your staff to make it happen.

Thank you very much.

Ms. **Tiffany**. Thank you, Mr. Shea.

Mr. Spievack?

STATEMENT OF EDWIN SPIEVACK, NORTH AMERICAN TELEPHONE ASSOCIATION, WASHINGTON, D.C.

Mr. **Spievack**. Thank you, Madame Chairperson.

On behalf of the North American Telephone Association I wish to thank the committee for this opportunity to address the interests of NATA's members in S. 898.

I have previously submitted a statement for the record and would ask that that full statement be incorporated into the record.

Ms. **Tiffany**. Without objection, the statements will be inserted in the record after the panel discussion.

Mr. **Spievack**. Madame Chairperson, I would like to believe that, as Mr. Henson suggested, S. 898 was fair to all participants in a newly competitive environment. Unfortunately, we do not see that.

We believe that among other things you might view the provisions of S. 898 as the Bell America Act. It confers a national franchise, we think, singling A.T. & T. out as the Government's chosen instrument of international telecommunications trade policy, of domestic telecommunications, data processing, and computer requirements, and of telecommunications and information services for national defense, security, and emergency preparedness.

As one might expect, a bill of that magnitude is going to confer substantial antitrust immunities, and we think S. 898 does.

The immunization is not explicit, but it is inextricably woven through the fabric of the legislation and into the legally approved structure of the Bell System.

At the threshold S. 898 first of all changes major judicial and statutory measures of dominant monopoly power. Rather than identifying a corporation's control of monopoly power on identified geographic and product markets, S. 898 defines "dominance" only in terms of those carriers that provide regulated telecommunications services in a substantial percentage of the total market for such service.

The definition limits the application of monopoly power to A.T. & T. and then, having defined it, instead of fencing it in the bill enlarges it.

With respect to customer-premise equipment and information services, it would presume and the bill does assume that the market is fully competitive and that A.T. & T. is entering a market in which it has no dominant monopoly power because the FCC seems to be deprived of jurisdiction to determine conditions of effective competition, as Dr. Selwyn indicated in the previous panel.

In our area of customer-premise equipment, A.T. & T. after 13 years of competition holds 91 percent of the market within its territory.

So what we see is that these markets are being disregarded as if there were a congressional will to bequeath a legacy of carrier dominance in the present and future development of those markets.

In terms of subsidies we would like to believe the problem is as simple as allocating common overheads. It is of course true that any multiservice, multiproduct corporation must and does engage in the allocation of expenses that are related to common overhead.

After 13 years of litigation the allegation of common overhead is not a problem—we emphasize "not a problem"—in terms of the cross-subsidy issue.

What is a problem is the shifting of direct costs for competitive services to the back of the regulated exchange ratepayer.

While it is frequently difficult to explain how A.T. & T.'s vertical integration functions from manufacturing through distribution the implications for competition are easily described.

The structure supresses competition. It is organized and managed to automatically transfer research, development, manufacturing, and marketing costs from competitive products and services to regulated local exchanges. This process is enormously profitable to A.T. & T., just as it is enormously detrimental to competitors.

By unburdening itself of product costs, Western Electric may run down the prices, and does run down the prices, of equipment and at the same time fix profits on a predetermined target.

If profits run into trouble because costs retained by Western Electric are too high, more of those costs are simply assigned to the regulated sphere.

As Dr. Baumol said before, there should be no reason, if costs run at $17 for some item, that a carrier should be charged, more than $17. When the cost runs to $17 and $25 is charged then competition is seriously and adversely affected despite the fact that competition has already suffered from these kinds of activities over the past 13 years.

The increase in operating costs to Bell-regulated carriers forces an incremental rise in the rate of return regulatory agencies must authorize for regulated services.

Consequently, A.T. & T.'s regulated carriers enter and A.T. & T. enters competitive markets without risk, fully able to wage price wars of limitless duration.

As there is no financial risk and limited risk to profit, the preferred carrier products and services are artificially priced to adversely affect the cash liquidity of competitive suppliers and to limit the growth and market shares that competitive suppliers might otherwise achieve.

The result of that is that, as Dr. Selwyn indicated, A.T. & T. can lower the price of products until competition is so severely restricted that production capacities are run down and then, as it is doing with its migration policy, raise the prices anywhere from 170 to 250 percent without it having an adverse effect on its own competitive position.

We have seen that happen. We have seen A.T. & T. run major corporations from various markets, and we have seen competition completely foreclosed in such markets as the States of Washington, Oregon, and Ohio. We have seen it severely lessened in other States.

The answer that S. 898 attempts to provide, as this committee knows, is that of the separate affiliate. However that theory of separation may be well advised to protect the future competition, the implementation is flawed in terms of its ability to dam the flow of subsidies across a border between regulated and unregulated services.

Instead of separation, S. 898 permits A.T. & T. to retain centralized control and management of the Bell System intact. It also enables it to move pieces of its system about like pieces in a jigsaw puzzle, to focus cross-subsidization at places in its business whenever and wherever it is needed to maintain and control markets.

The separate affiliate, although supposedly separated from the financial support of A.T. & T. and the regulated carriers with which A.T. & T. is affiliated, can nevertheless enter into contracts, joint ventures, and partnerships with A.T. & T., and affiliated carriers of the Bell System.

These arrangements provide for the sale and exchange of property, joint financing; furnishing of goods, services, and facilities used in common for regulated and unregulated business; and for the transfer of commonly used assets.

Western Electric, in addition, can perform installation and maintenance services for the customer-premises equipment marketed by the separate affiliate even though Western itself is not separated and is sustained by the revenues of regulated services.

To assure that costs of product development and information services will not translate into prices prohibitive to the maintenance of A.T. & T.'s traditional markets or into prices antithetical to the growth of A.T. & T.'s new markets, the separate affiliate is guaranteed under the provisions of S. 898 with the availability of initial and future subsidies.

At current levels of $3 billion annually, S. 898 shifts Yellow Pages directory advertising into the separate affiliate for customer premises equipment, data processing, and resale transmission facilities.

But if this subsidy which is based on the control the regulated network proves insufficient A.T. & T. is given the option of transferring all or part of the long-distance network into the subsidiary whether it remains subject to regulation or not.

We think these provisions make the notion of separation cosmetic and certainly hold the potential for enormous damage to the future of competition, whether that competition is supplied by NATA members or future competitive activities of United Telecommunications.

In two areas S. 898 represents a radical departure from what we have previously seen. Those involve international trade and national defense, security, and emergency preparedness.

S. 898 contains explicit provisions through which A.T. & T.'s entry into international trade is subsidized off the back of the local exchange ratepayer.

The corporation is totally free of the cosmetic necessity of separating its regulated and unregulated services when conducting business in foreign telecommunications markets even though that trade is explicitly deregulated.

Therefore, profits from foreign trading activity can be maximized by the authority S. 898 confers to shift the regulated development, manufacturing, merchandising, and distribution costs to regulated services.

Concomitantly, U.S. domestic manufacturers unaffiliated with carriers are threatened by the potential displacement of their prior entry into foreign markets.

S. 898 with abundant clarity authorizes A.T. & T. to extend its domestic price war into emerging international trading markets which A.T. & T. competitors and not A.T. & T. created.

The other especially worrisome feature of S. 898 is its decision to eliminate competitive bidding for telecommunications products and services by executive agencies of the U.S. Government.

This is one example of history's ironies—that a Republican administration under President Nixon opened up competitive bidding and that a Republican administration under President Reagan is now attempting to close it out.

S. 898 confers power on the President to determine that the interests of national defense, security, and emergency preparedness require that all telecommunications services, facilities, and equipment shall be furnished to executive agencies of the United States exclusively by a carrier.

In such circumstances the bill provides that the separation of regulated and unregulated activities, as illusive as those are, nevertheless do not apply at all.

Obviously, we think they could not apply given the structure of the bill; but flexibility we think is needed on both sides. The Government must have the best products and services ratepayer subsidies can supply, but if the ratepayer burden becomes a political embarrassment Government acquisition costs must be high enough to sustain A.T. & T. unregulated international and domestic operations to preserve its financial integrity in the capital markets of the United States.

Most significantly in terms of the antitrust laws themselves, S. 898 converts previously unlawful conduct, if caught and determined, into lawful conduct impervious to legal challenge no matter how destructive to consumer and competitive interests.

It fulfills two of the main purposes of A.T. & T.'s legislative program. It legislatively eliminates the 1956 consent decree under which A.T. & T. voluntarily agreed to withdraw from all markets other than telecommunications service subject to public regulation.

But equally if not more critical, it assures that the Government's pending antitrust case against A.T. & T. cannot jeopardize the central control and vertical structure of the Bell System as it now exists.

S. 898 is quite explicit. It requires that any research, development, and manufacturing which is to be conducted exclusively through a separated affiliate of A.T. & T. shall be owned by that affiliate.

Therefore any court decree ordering the divestiture of Bell Labs and Western Electric as unseparated affiliates of A.T. & T. would only have the effect of accelerating the transfer of those entities to the so-called separate affiliate. In effect, a court-ordered divestiture would merely telescope the 6-year transition plan established in the bill.

S. 898 suffers numerous other infirmities. Contrary to the proposed purposes declared in the bill it is clearly intended to create, we believe, results destructive of competition.

Perhaps the best proof rests in the provision that expressly authorizes all unregulated carriers defined as telephone companies having revenues of less than $100 million to deny all interconnection rights for competitive telecommunications services and customer-premises equipment 2 years after the date of enactment.

In short, if competitive industries have been successful it is obvious they are now to be penalized for that success.

The Senate Commerce Committee's bill is suffused with issues bearing on questions of national competition and antitrust policy. The adequacy of separation requirements bears directly on the future viability of competition in telecommunications and of competition in information services and products which mark the advent of a postindustrial society.

Because that future is under attack it is time to explode the myth that communications legislation is designed to promote competition and to forthrightly face the question of whether and to what extent the future of information and telecommunications services is best served by monopoly concentration or what the proper mix and balance of competitive and monopoly influences should be.

The decision to relieve A.T. & T. from the constraints of the 1956 consent decree and from jeopardy of the pending Government antitrust suit should be similarly addressed in the light of what is intended. It should not remain hidden behind a facade of antitrust savings clauses which have no legal meaning or effect.

Congress cannot say that the legislation is not intended to affect present or future antitrust litigation and at the same time say a fully separate affiliate of A.T. & T. is required to own the research and manufacturing capacity for products it distributes. It takes no great legal mind to understand that a court cannot order the divestiture of what A.T. & T. is legally required to own.

Speaking for the members of the North American Telephone Association, it is our hope that this committee will intercede in redrafting S. 898 to establish competitive fairness and balance.

It is our hope that we may work with the staff of your committee to cover all those provisions of S. 898 which are in critical need of change so the promotion of competition will truly represent a policy of this Congress.

Thank you very much.

Ms. TIFFANY. Thank you, Mr. Spievack.

I do have some questions to address to all three of you. However, as with the last panel, should a question be of interest to you and you would like to address it, or should the answer of the person to whom it is addressed intrigue you and you want to respond to it, please feel free to do so.

Mr. Henson, what kind of a working relationship exists between A.T. & T. and United Telecommunications, and would divestiture of portions of A.T. & T. as proposed in the antitrust suit impact that relationship?

Mr. HENSON. A.T. & T.—the operating company—and the operating companies of United Telecommunications together form the part of the core network on which the basic message toll and WATS traffic is carried.

We are partners in the provision of that network and with complete uniformity of standards and interconnection. One can best characterize our relationship at the moment as a partner in the provision of intercity services—message toll, WATS, and private line services.

Divestiture of the operating companies—is that the premise you are addressing?

Ms. TIFFANY. Yes. I believe in the Justice Department the remedy sought is divestiture of the local exchange operating areas and separating that from the Long Lines equipment operating at Bell Labs.

Mr. HENSON. Yes. The relationship with those individual Bell System operating companies presumably in the provision of intrastate or confined intercity services where we connect directly with a Bell-associated company would not be disturbed.

The disruption would come in the Long Lines portion of the network where we interconnect with a Bell System company and they, in turn, interconnect with the Long Lines division of A.T. & T. That is the point at which interface must be standard and protocols appropriate in order to have an integrated nationwide network.

If A.T. & T. were still the only intercity provider of traffic between the operating telephone companies of the United system and of the Bell System presumably coordination could be obtained, but that is not quite the way I understand the divestiture remedy.

There would be other intercity carriers with different kinds of standards for interconnection and transmission. Just what that relationship would be I am really unable to say. It has never been done. It is one of those things that I simply do not know the answer to at this point.

Ms. TIFFANY. But there is no clear indication that it would necessarily interfere with your operations and with the orderly conduct of your telephone service?

Mr. HENSON. Presumably, if standards could be maintained and interconnection agreements could be obtained. I have no idea what the revenue effect would be; and at this point in time, I do not think anyone would have any idea.

There is the question of how much market you would retain under that scenario. Hence, I am not trying to project the revenue aspects of the situation; I am just trying to look at the operational side of the question.

Ms. TIFFANY. As a regulated carrier you have probably had a number of dealings with the FCC in the past. In your opinion, is the FCC capable of accomplishing the kind of cost accounting it would be required to do under S. 898 in order to detect and prevent cross-subsidization?

Mr. HENSON. Certainly I think the FCC is capable of monitoring a uniform system of accounts and determining if there are any cross-subsidies between regulated and unregulated businesses.

For some time we have advocated that we ought not to try to reinvent the wheel in the determination of a uniform system of accounts. There is an accounting profession out there. There have been methods of cost allocation and cost identification for years—generally accepted accounting practices.

If such a uniform system of accounts could be approved by the FCC, I think that agency is certainly capable of monitoring the impact of a newly devised and implemented uniform system of accounts.

Ms. TIFFANY. How about capability in doing cost accounting such as would be necessary to determine whether a particular rate is cost justified? Have you had an experience with the FCC in engaging in those kinds of reviews, and what do you think of their capability to accomplish that?

Mr. HENSON. Only indirectly has United been involved. In most situations we are a concurring carrier. As a consequence, the costing methodology and the cost studies are performed by A.T. & T. and the Bell System operating companies. However, we have been more than casual observers to the process.

Once standards of costing methodology are determined reasonable people can agree on how to apply those methodologies.

Unfortunately, there has not been a solid set of methodologies adopted by the FCC. Hence, that gives rise to the so-called unlawful filings that have arisen.

Ms. TIFFANY. Do you have any ideas why it has not been possible to adopt a consistent methodology?

Mr. HENSON. I suspect it is much like why we have not adopted a national telecommunications policy. There are a lot of players. Every time a system is proposed someone objects, obviously very objectively; but once in a while it appears that self-interest is being expressed; and methodology for costing has been just as bitterly debated as has national telecommunications policy.

Ms. TIFFANY. Do you think there is going to be any better success under S. 898?

Mr. HENSON. Yes. I think the framework is there.

Ms. TIFFANY. You note that S. 898 diminishes the ability of A.T. & T. to engage in cross-subsidization because of the scrutiny of the public and the FCC over the regulated services. Do you think that, in line with this idea that the scrutiny will decrease cross-subsidization, it might be appropriate to require some kind of outside stock ownership—some percentage of stock ownership by others in the A.T. & T. affiliate?

Mr. SHEA. Our position is that divestiture is the only real solution that is going to achieve the kind of competitive parity that we are looking for, and it is going to avoid the twin evils of cross-subsidization and tying.

Short of that, I think a minority equity position is the only tenable alternative that our association would support, and it could work. That has to be coupled with FCC reporting requirements.

Mr. Henson was talking about cost accounting and accounting methodology. We have had quite a bit of experience with the SEC as well, both as a company and as an association. We have not seen an accounting method that works.

One of the things we are trying to do is to detect evidences of cross-subsidization of tying, and an accounting system is not the appropriate vehicle to do that. It simply will not work. Historically it has been proven not to work. Nobody has thought of an effective one yet.

So yes, to answer your question, minority equity interests would be a compromise position for us; but as an association we would support it were it coupled with SEC reporting requirements.

Ms. TIFFANY. Mr. Henson, would you care to comment on the minority stock ownership proposal?

Mr. HENSON. Yes, I would. I am not convinced that minority ownership of a fully separated affiliate would really accomplish much more than dilute the ability of management of that company to manage.

I recognize that there are additional reporting requirements under the SEC reporting rules, yet I fail to see that it is going to do very much good to increase the visibility. What we are apparently most concerned about here is the ability to cross-subsidize.

I believe that, under the provisions of S. 898 and with resale and sharing, there is just simply no reason for the fully separated affiliate and indeed the parent company, A.T. & T., to try to cross-subsidize.

The minute they start to do so, if indeed these competitors are as good as they say they are, they will start to take market share. That is what competition is all about.

With 10 percent or 20 percent or any other percentage short of 51 percent, I do not see that you are really increasing the visibility that materially. I am ambivalent on it.

We operate with minorities in some of our subsidiaries. It is difficult. I heard Mr. Trienens say that they get sued by all sides. That is just another one of the risks of doing business.

Ms. TIFFANY. I expect there are going to be a lot of lawsuits whether or not there is going to be minority stockholder ownership under this particular piece of legislation.

Mr. HENSON. That is so.

Mr. SHEA. I have to disagree very strenuously with Mr. Henson on that point. There is not only the opportunity, there is the ability of A.T. & T.'s cross-subsidization of its affiliate under this bill as presently constructed.

Just going back to the litany of things that I mentioned in my testimony where you have shared offices, shared facilities, and the free transferability of employees, you are talking about cross-subsidization not only of capital but also of information.

Let me take a moment, if I may—and I think this is very critical for your understanding—to talk about the relationship that we would have with A.T. & T. if this bill were enacted as it is presently drafted.

I mentioned that it has already been somewhat exacerbated because of the tremendous rate increases we have experienced at the Commission, which A.T. & T. has pushed for strenuously, and our objections have gone unheeded. We are looking at highly inflationary increases of up to 100 percent in nature.

Post-S. 898 we are looking at the prospect of our principal supplier—our one absolutely essential supplier—becoming a direct competitor.

As a competitor it would have intimate knowledge of our entire business. A.T. & T.'s marketing philosophy simply requires, particularly for national accounts such National Data, that customers divulge confidential information.

A combination of that plus A.T. & T.'s monitoring of our line utilization and the free transferability of employees all tend toward the inevitable cross-subsidization of information. We are looking at the inevitability of that competitive, proprietary information being divulged and being misued to anticompetitive ends. There is no way to avoid that.

Ms. TIFFANY. Mr. Henson?

Mr. HENSON. May I add a postscript? We happen to operate a computer timesharing company ourselves with revenues of about $115 million. We are dependent on A.T. & T. and on the specialized common carriers such as Southern Pacific and MCI for our transmission facilities.

The United Telephone companies provide only a very small smattering of the transmission capability utilized by United Computing Systems.

We do not divulge any confidential information to A.T. & T. or anyone else, and I am not sure where Mr. Shea is coming from on that kind of an allegation.

It is quite easy to make allegations as to what might happen. I think it is time that we decided that we are either going to have a competitive environment out there or that indeed the economies of scope and scale are such that perhaps it should be a regulated monopoly.

Mr. SHEA. Let us talk then, Mr. Henson, about real world problems. My companies' businesses were built on WATS—wide area telephone service. We are one of the Nation's largest users of WATS.

Our market, our customer base, our products, our services, our opportunities were not initiated solely by National Data and its planning department. They were built and created hand-in-hand with A.T. & T. and the Bell System.

A.T. & T. fostered our use of WATS, aided us in product planning, and aided us in market development, to the point where we are now the Nation's largest cash management provider and the largest independent credit authorization provider. Both those services depend very heavily on WATS.

We are now faced with the Commission's latest WATS restructuring and increases—a net increase of over 100 percent in WATS charges.

It is indeed ironic that National Data and other major remote access data processing suppliers are the principal victims and suffer the worst rate increases as a result of the WATS restructure. That is incredibly ironic.

Mr. HENSON. It is ironic, but it was ordered by the FCC.

Mr. SHEA. And fostered by A.T. & T. The large users are taking the brunt of the increase—those users are A.T. & T.'s potential competitors—under this legislation.

You have already got an instance of anticompetitive conduct.

Mr. HENSON. Perhaps you know more about FCC proceedings that I do, Mr. Shea, but I think the WATS pricing structure was really advocated and developed by the FCC, certainly authorized.

Ms. TIFFANY. Gentlemen, I would like to move on to another topic.

Mr. Henson, if you were to offer one amendment to this bill that you think would improve it significantly, would you be able to come up with one?

Mr. HENSON. Yes. The one thing that I would suggest, Madam Chairperson, is that there be a reasonable time limit on those exclusionary provisions. If indeed we are talking about a competitive marketplace as these gentlemen want to talk, then everybody ought to be allowed to compete. It is a lawful business pursuit, and there are at least three select areas that have been carved out for protection—CATV, electronic directories or information services, and recently the alarm and signal industry.

If we are going to have a competitive environment in telecommunications and if those markets are not reasonably served within a 3- to 5-year timeframe, then I say the exclusionary provisions ought to run out.

Ms. TIFFANY. Thank you.

Mr. Shea, in your written testimony you used the phrase "maximally separate subsidiary." Would you briefly summarize what you feel would be the essential elements of such a subsidiary?

Mr. SHEA. A maximally separated subsidiary is almost a contradiction in terms. As I have indicated earlier, the only effective way to restructure the Bell System in a competitive environment is through divestiture.

If you adopt a maximally separated subsidiary—and indeed that is a compromise position for our association, as I indicated earlier—you have to have a minority equity interest that is substantial and that requires SEC reporting.

You have to obviate the necessity for the opportunity for joint ventures, shared offices, and shared facilities. You have to preclude A.T. & T. from guaranteeing the debts of its affiliate. You have to stop A.T. & T. from transferring employees between parent and affiliate. You have to force A.T. & T. to deal with its affiliate on a total arm's-length basis. You have to separate basic and applied research. You have to stop A.T. & T. and its affiliate from using a common name and common logo, with no joint advertising. You have got to have FCC oversight to take a look at the whole structure once it is in place.

Ms. TIFFANY. Mr. Spievack, we have not heard much from you.

Mr. SPIEVACK. No. I am too old to get into this kind of thing. [Laughter.]

Ms. TIFFANY. S. 898 differs from some of its predecessor legislation in that it defines a dominant regulated carrier and focuses its provisions on that carrier. Would you comment on this modification of this legislation?

Mr. SPIEVACK. I guess I will preface my answer by saying that in terms of the definition of "dominance" for A.T. & T. we have seen that before. What 898 does is this: With respect to telecommunications services for regulated carriers, whoever they are, it requires that the effectiveness of competition will be determined by the FCC on the basis of power within geographic and product markets.

Those are traditional antitrust kinds of measures that are used by courts and found in the interpretation by courts of the antitrust laws.

The definition for A.T. & T., however, is radically changed. Dominance is based on providing telecommunications service in a substantial percentage of all 12 communications services or submarkets of the United States.

That means you look only to A.T. & T. power in certain markets, whatever they are—and it is not clearly defined in terms of the percentage of power they have over the entire United States—whereas, for example, they may be totally dominant, say, in customer-premise equipment within a geographic market such as Ohio, Washington, or Idaho, and may have close to 100 percent of the market in those geographic territories.

There may be no competition at all, yet in looking at the total picture from the redefinition set down in S. 898 there would be no way to reach that kind of geographic and product dominance because the FCC is deprived of power to reach it and the act itself says that as long as A.T. & T. is operating through that fully separate affiliate there is not much you can do about it.

Ms. TIFFANY. What particular problems do you see that as raising?

Mr. SPIEVACK. I think it was described fairly clearly by Drs. Selwyn and Melody. The underlying assumption of S. 898 is that competition exists—that there is effective competition out there today—and that therefore you do not have to worry about it very much.

Dr. Baumol says we seek protection, and I think that is a bit nonsensical, with all due respect to Dr. Baumol. We are not seeking protection. We have had 13 years of litigating with Bell over cross-subsidy, and we know it exists.

I guess because we are tired and old we are not even willing to say at this point that it should not exist. It is only a question of how much and whether or not it can be controlled in sufficient ways to assure that it does not have an adverse effect on competition.

What we see as the major deficiency of this bill in terms of customer-premise equipment and in terms of future information services is that there is no way to challenge the exercise of monopoly power if it is having an effect on competitive growth and development.

I recognize the fact that Dr. Baumol likes to talk about the economies of scale and scope; but after 13 years of litigation, of Bell witnesses telling me on stands and under oath that there are no economies, that any time anyone has 5 percent of the market they have achieved all the economies of scale that can be achieved, then I think you have to begin to look at the reasons why Bell's pricing is where it is and Bell prices in the way in which it does.

It is not because Bell is in some way improperly misallocating common overhead costs. It transfers the major costs of marketing, research, and development, distribution, and in some cases manufacturing, and certainly labor installation and maintenance, to basic exchange and removing them from the competitive services and equipment to which they apply—putting them on the backs of the exchange ratepayers. In those circumstances there is no way you can compete unless Bell decides she wants to let you compete.

One of the major problems of this bill is the decision as to how much any one will compete is up to Bell. The Congress is really consigning that decision to A.T. & T.

Just as we did not want Bell to have the decision as to how much competition could be achieved when Bell was controling the market—it took us 7 years to get done with that decision—we do not want to have the future control of the extent to which competition is achieved decided by them.

We are not worried about some minor assignment of common overhead expense. I do not even think that many of our members get very excited over this issue of divestiture. There is a lot of sense in which divestiture really misstates the issue.

Some of our members, like Mr. Shea's members, want to see divestiture, but the important thing is not a question of divestiture. The important question is whether or not the competitive industries are going to have a forum in which we can seek redress and in which we can obtain relief if there is a problem.

If A.T. & T. were willing to have what Mr. Shea refers to as maximum separation, in which there would be no possibility of any cross-subsidization because the lines are drawn so tightly between its regulated and unregulated business activities, that there could not be any flow of revenues across that line, and there could not be any joint ventures or partnerships, any transfer of assets, any joint financing arrangements, any consolidation attached to the terms, or anything else—if the separation were that tight you could say maybe it would all work even though A.T. & T. has a monopoly dominant share in all these markets.

If you are going to have a separation which is as loose as S. 898 draws that line, in which the line is not a dam but is like a sieve, then I am saying to myself:

> Don't worry too much about what the potential meaning of that is—whether or not there is sufficient regulatory authority to control it. If A.T. & T. gets out of line, that Government decision can umpire the battle.

It is not just a simple question of regulation versus deregulation or getting rid of regulation. Deregulation will not make competition. Deregulation is only a means of getting Government out of businessmen's hair where it is necessary to do that.

Where you have got a monopoly as dominant as this you are going to need regulation through some significantly long period where effective competition is forming in growing.

In the alternative, you are going to have to have very severe and stringent separation of requirements which A.T. & T. will not accept.

The question then becomes: What is the middle ground that A.T. & T. will accept? We do not know that answer.

Ms. TIFFANY. How do you view the adequacy of the Federal courts in antitrust actions as a forum to resolve these kinds of problems?

Mr. SPIEVACK. Totally inadequate.

Ms. TIFFANY. Why is that?

Mr. SPIEVACK. It takes too long. The legal talent that is brought to bear on it is going to use the antitrust court for the purpose of seeing whether or not it can wear out the opponent.

There is not going to be any settlement or any possibility of settlement in any antitrust court until the defendant's attorneys are able to conclude that they cannot wear out their opponent, and then they will begin to talk settlement, and that is a 5- to 6-year process.

With all the warts on the FCC, with all its deficiencies and inadequacies, with all its unwillingness to decide things allegedly on the basis of insufficient budget and staff, you can get a decision faster. It depends on whether you happen to be using the right procedure or not to get the decision, but you can get the decision. It is a much more expeditious way to go.

I have been before regulatory forums for the last 13 years, and the commission with the smallest staff and budget, with practically no manpower at all, and is the most efficient commission in the country, is out in Colorado.

The commission with the largest staff and budget of any commission in the United States is down in Florida, and it is probably the most inefficient.

When I was on the FCC we used to complain about insufficient staff and budget. The answer to that was that we go around and find people who were not working because they did not have enough people to do it so they did not start anything.

Fundamentally, what happens in a regulatory commission is an act of will. If you want to make a decision that decision will get made just like that.

Mr. Henson is absolutely right: There is no reason in this world why the FCC has to cogitate the issue of a uniform system of accounts for the next 5 years.

Accounting principles and standards are well enough known so that any good accounting firm can go into the FCC and set up an accounting system if they had decided what that accounting system was supposed to do.

If you said to the accountants: "We want you to establish an accounting system which establishes a profit center operation for A.T. & T. over customer-premises equipment," they would do that, and they would do it in a couple of months.

If you said: "We want you to set up a cost accounting system that establishes a profit center accounting structure for transmission facilities," they would do that, and it might take them a few more months, but they could get it done. Nobody has made the decision to get it done.

As far as costing principles are concerned we have been through enough cases, unlike Mr. Shea, so we do not care what the costing methodology is. You can use fully distributed costs; you can use marginal costs; you can use incremental long-run costs; you can use incremental short-run costs; and we will show you that under every methodology A.T. & T. is underpricing the equipment because so much of the cost is being shifted away from the accounting and economic structure, where it is supposed to be, that it does not really matter what costs you use.

We have never been in a case in 13 years where we have argued for any method of cost. We have said to the Commission: "Take any one you want—whatever makes you feel good, whatever you like. If you want fully distributed cost method 7, if you want long-run incremental costs, fully distributed costs, marginal costs, indirect, or direct costs—take any you want, and we will still show you it is under cost."

Ms. TIFFANY. You believe that if the FCC just got organized it would be able to set up a cost system that would detect cross-subsidization?

Mr. SPIEVACK. Mr. Henson and I will go over and show them how to do it.

Mr. HENSON. Well, I hate to intrude on this monolog. I am fascinated with my friend's comments. However, I should think that this litany of horrors that Mr. Spievack has cited in the pricing of customer-premise equipment under regulation ought to make him an ardent advocate for S. 898. At least with one of the costing methodologies, you will have a very good case to make them price according to their costs, however those costs are defined.

Mr. SPIEVACK. I would agree with you, Mr. Henson, if I did not have Yellow Pages directory advertising in there.

Mr. HENSON. After you and I set up the accounting system that is going to be identified, too.

Mr. SPIEVACK. OK. That is right.

If he and I were setting up the accounting system and there was some umpire there looking at that accounting system he and I could do that assuming A.T. & T. did not get in the political way of it.

The problem is that S. 898 does not impose an accounting structure over that deregulated activity. S. 898 leaves you no forum in which you can seek redress if there is a mistake made in that unregulated subsidiary. You have got to go to antitrust court.

By the time we get done with antitrust court Mr. Henson as a competitor and my client as a competitor will be gone unless Mr. Henson stays out of this area of customer-premise equipment, which is questionable anyway.

Ms. TIFFANY. Mr. Shea?

Mr. SHEA. To get back to this question that you raised and which we have kind of circumvented here recently—on the Government's antitrust suit against A.T. & T.—I think the key issue is not whether one likes or dislikes, accepts, or rejects that litigation because the litigation is proceeding at pace.

I think the key issue for this committee to consider is: What is the impact of this legislation on the litigation? As we see it, this litigation will be an interference with that antitrust process.

Last year the Department of Justice testified on the H.R. 6121 hearings, and the Assistant Attorney General made that very comment—that the bill would impede his efforts in litigation.

I know you have invited Justice to testify before this assembly. I would recommend to you that if they decline you subpena them. You absolutely need their input in order to make an effective determination as to the impact of this bill on the antitrust litigation.

The second reason I feel that this committee should be involved in the bill is the fact that it interferes with a consent decree that has been around for 25 years and that has worked. This legislation would effectively abrogate a judicially-imposed consent decree.

Third, the bill would have a tremendous negative impact on companies and markets other than telecommunications, such as data processing services.

So you are not just looking at the impact of the restructuring of the Bell System on the telecommunications industry; you are looking at a much broader application over a much wider number of companies and industries. I think you have got to be involved.

Ms. TIFFANY. Thank you.

Mr. Henson, do you have any further comments to make?

Mr. HENSON. No, I think not. Thank you.

Ms. TIFFANY. Mr. Spievack?

Mr. SPIEVACK. No, I think not.

Ms. TIFFANY. Thank you, gentlemen.

That concludes this hearing. We will be in recess until July 29 at 1 p.m. in this room.

[Whereupon, at 3:50 p.m., the hearing was recessed, to reconvene on July 29, 1981, at 1 p.m.]

[The prepared statements follow:]

STATEMENT
OF
PAUL H. HENSON

Mr. Chairman, I am Paul H. Henson. I am Chairman of the Board and Chief Executive Officer of United Telecommunications, Inc.

I appreciate the opportunity to appear today and provide our views on S. 898 and particularly on the impact of the bill on competition in the telecommunications industry.

United is on record as fully supporting S. 898. Now that the measure has been favorably reported out of the Committee on Commerce, Science and Transportation, we continue to urge its immediate enactment. The reason for the urgency of such action is that the telecommunications industry has operated under an uncertain regulatory climate long enough. Everyone involved in this industry -- providers of services, consumers and investors -- needs a national telecommunications policy designed for the future and for full competition which can be relied upon with some degree of assurance. We believe that S. 898 provides that needed certainty.

On the other hand, we do not view S. 898 as the final answer to all the industry's problems. Rather, we see it as an acceptable attempt to update the nation's telecommunications policy. At this time in the industry's development, any meaningful regulatory policy statement must address the issue of monopoly versus competition. We are not yet at a point where all telecommunications services can be completely deregulated. The national interest requires that the basic nationwide telecommunications network be preserved in order to assure the continuation of basic telecommunications services on a universal basis at just and reasonable rates and for national security reasons. However, as technology advances, new and innovative services and products should not be constrained by burdensome regulation. The public deserves to have these innovations implemented as soon as practicable. We believe competition will provide the stimulus for the prompt introduction of new technology and the innovation of new and improved telecommunications services and products. This balancing of continued basic service and implementation of improvements and innovations requires specific trade-offs. United believes that S. 898 makes trade-offs which, with a few exceptions, are necessary to accomplish the proper regulatory goals and which are equitable to all parties concerned. The exceptions I have in mind are exclusionary provisions which permanently prohibit a regulated carrier from engaging in certain lawful business activities. We understand the reasoning which has led to these provisions, but in the absence of some reasonable time limitation, they are fundamentally anticompetitive in character. They should be removed or limited in duration.

To fully understand United Telecom's role in the telecommunications industry, I would like to briefly describe our operations. United Telecom is a holding company and consists of three major groups, each group operated or administered by a separate corporate entity. The first group, the United Telephone System, consists of 26 operating companies and is the second largest non-Bell telephone system in the country. In 1980, it had nearly five million telephones in service throughout many smaller communities in 21 states and an investment in plant of over $4.5 billion. It has approximately 26,500 employees.

The second group, United Communications Systems, is largely engaged in marketing competitive telecommunications services and products which are not regulated. The principal company within this group is North Supply Company. North Supply provides products to all segments of the telecommunications industry, including interconnect companies, international telecommunications markets, electrical utilities, security and alarm systems, and CATV systems. Sales of North Supply in 1980 were approximately $400 million. This group is also exploring opportunities presented by emerging telecommunications technologies.

The third group is United Information Systems, which provides remote computing and data network services. Its revenues in 1980 were about $115 million. This group offers a wide variety of business, technical and financial services via communications networks serving over 150 cities linked to computer centers in Kansas City, Boston, Pittsburgh and London.

As can be seen from this description, United is engaged in a wide number of telecommunications services and either is or intends to be in competition with AT&T and other giants of the industry. Although we are smaller than some competitors in the telecommunications industry, we vigorously support the concept of full and fair competition. On the other hand, we oppose those who seek legislation designed to protect a specific industry from the rigors of full and fair competition. We believe it to be contrary to the public interest for Congress to adopt a national telecommunications policy designed to protect a specific segment of that industry from competition. Unfortunately, S. 898 contains provisions which in fact do protect certain industries from competition. We continue to urge the modification of these provisions, even while acknowledging that the need for legislation and the certainty it will bring to the entire industry outweigh the disadvantages inherent in such limited exclusionary provisions.

We frequently are asked how a company the size of United can compete against larger companies, such as AT&T, GTE, IBM and others in the telecommunications industry. While AT&T and other larger companies enjoy economies of scale and other advantages which may be helpful to them in a competitive market, we fully believe and are confident that we also have certain advantages. We believe because of our size we can respond more quickly and more efficiently to market forces and can become an effective participant in the new and evolving telecommunications markets.

I would like to address one subject relative to competition which has been raised in connection with S. 898 -- that of cross-subsidies. Cross-subsidization can take various forms. Thus, it would be well to first define where cross-subsidies potentially can exist and then to discuss how we believe S. 898 adequately deals with those situations.

Cross-subsidies can flow from regulated monopoly local exchange service to monopoly or competitive intercity toll service. They also can potentially flow from other regulated monopoly service or product offerings to competitive services or products.

In the case of possible subsidies from local exchange to monopoly or competitive intercity toll, S. 898 contains a provision (Sec. 222) for modifying the rules governing cost allocation and for establishing access charges. Under S. 898, a Joint Board is to determine costs of local exchange services and access to local exchange, and to apportion those costs between local exchange services and local exchange access. The FCC then establishes practices to determine and apportion such costs, so as to assure the realization of uniform and nondiscriminatory charges for comparable types of interconnections. In order to accomplish the foregoing, the FCC has the power to prescribe the form of accounts to be maintained by exchange carriers and the filing of tariffs containing access charges which are also subject to FCC review. This will assure reasonable and nondiscriminatory access charges for interconnection to local exchange service.

We believe that Section 222 of S. 898 contains adequate assurances to preclude any unlawful or undesirable cross-subsidization of intercity services by local exchange service. This provision requires the FCC to apportion exchange costs between exchange service and exchange access and to ensure the "universal availability of basic telecommunications service at reasonable charges." Under the process set forth in Section

222, the achievement of the goal of universal availability is necessary if we are to maintain and promote an efficient nationwide telecommunications system which is available to every citizen of the country. The bill contains safeguards to achieve equitable treatment of carriers and customers and to assure that payments and assignment of costs are publicly visible.

In the situation of possible subsidies from monopoly to competitive service or product offerings, we believe that S. 898 contains a comprehensive set of provisions which will adequately guard against such anticompetitive practices.

The most notable of the provisions are found in Sections 227 and 228 of the amended 1934 Communications Act, which require AT&T, as the dominant regulated carrier, to establish a fully separated affiliate for its competitive service and product offerings. The burden is on AT&T to submit a plan to the FCC evidencing proper compliance with S. 898. The separate affiliate is also precluded from offering any such competitive services or products until FCC approval of such plan is obtained. The FCC is given specific authority to deal with anticompetitive practices between AT&T and its separate affiliate. Each violation is subject to a fine of $1 million. The structural requirements deal with separate accounting, marketing and sales, maintenance, operation, manufacturing, development and applied research activities. These provisions mandate that all transactions between AT&T and the separate affiliate are to be on a compensatory, fully auditable, and arms-length basis.

United believes that the separate affiliate provisions contained in S. 898 are adequate. They provide for full separation between the regulated and nonregulated competitive businesses of AT&T. Any attempts to cross-subsidize would be highly visible. If potential competitors seek further separation, we can only conclude that they are advocating protectionism.

S. 898 also contains other provisions which are applicable to all regulated carriers and which will also serve to adequately guard against cross-subsidy between regulated and competitive services. The FCC is required to prescribe an accounting system for regulated carriers so that revenues and costs are properly allocated between regulated and unregulated services. All regulated carriers are required to file with the FCC copies of all contracts and other agreements relating to regulated services. Likewise, all carriers must file tariffs with the FCC which contain the rates and conditions of the regulated services offered. The FCC is given authority to make certain these tariffs are lawful. Finally, all regulated carriers must notify the FCC of construction of new facilities. In addition, AT&T, as a dominant regulated carrier, is required to obtain FCC certification to add, modify or reduce facilities.

Thus, S. 898 establishes requirements to maintain the FCC's and the public's scrutiny over the provision of regulated services by all carriers. Under such regulation, it is seemingly impossible for AT&T to engage in cross-subsidy of a competitive service from a regulated, monopoly service. United believes the provisions of S. 898 are adequate to prevent cross-subsidies in such situations.

In conclusion, United submits that telecommunications legislation is necessary at this time to provide stability to the industry and, to encourage the implementation of new and improved technology, for the benefit of the served public. We further submit that S. 898 embodies those provisions which will accomplish desired public interest goals and which will more readily assure that full and fair competition will flourish in the telecommunications industry.

STATEMENT OF
GEORGE M. SHEA

Mr. Chairman and Members of the Committee:

My name is George M. Shea. I am Vice President, Secretary and General Counsel of National Data Corporation of Atlanta, Georgia. I am also a member of the Board of Directors of the Association of Data Processing Service Organizations, Inc. ADAPSO, as the Association is more commonly known, is the trade association of the computer services industry.

I want to thank the Committee for this opportunity to express the views of my company and my Association with respect to S.898, the Telecommunications Competition and Deregulation Act of 1981.

My company and others in ADAPSO are members of a highly competitive, innovative, and thriving industry. In 1981, our annual revenues will approach $20 billion. The industry's over 11,000 participants, the overwhelming majority of which are small businesses, provide the American and worldwide public with a broad spectrum of computer services. These include such diverse offerings as local batch processing; software design, development, support and sales; facilities management; and remote data processing services.

The latter remote computing services enable geographically dispersed customers to access distant centralized computers for both interactive (timesharing) and batch data processing purposes. The connection between the customer and the computer is achieved through the use of common carrier communications services. In other words, communications facilities are used to deliver data processing services to subscribers, much the same way that the mails, trucks, and other means of transport are used to deliver physical goods to customers that are geographically distant from factories and stores.

Unlike other industries, however, remote data processors are totally dependent upon one, basic means of transport to deliver their services to the public--communications facilities that usually include private line circuits as a necessary component. As the members of this Committee are well aware, the overwhelmingly dominant provider of such service in the United States is American Telephone and Telegraph ("AT&T"). Through its Long Lines Division and its telephone operating companies, AT&T exercises almost exclusive control over access to the nation's long distance and local telephone networks. Consequently, remote data processors, such as my company, as well as our customers are completely dependent upon AT&T in order to provide computer services to the public.

My company's interest in S.898, as well as that of the other members of ADAPSO, is therefore a function of our dependence upon the availability of high quality and reasonably priced communications services. In today's market, in which the computer services industry stands in a customer-supplier relationship with AT&T, we encounter problems with respect to the cost, quality, and availability of service. If AT&T were permitted to become a competitor as well as supplier to computer services vendors without adequate competitive safeguards--and I want to stress the use of the qualifier "without adequate competitive safeguards"--these problems would be exacerbated.

In such an environment, AT&T would have both the incentive and the opportunity to use its monopoly power and resources, and its control over the communications network, to destroy or at least inhibit competition. As both a competitor and supplier of service to the computer services industry, AT&T would be uniquely situated to engage in tying and other forms of unfair competition. As the predominant provider of telecommunications service, AT&T could easily misuse privileged information about the network, its customers, and its customers' customers.

Similarly, AT&T could manipulate the quality, availability, restoration and maintenance of service for anticompetitive ends. Because of AT&T dominance and its ability to establish de facto standards, AT&T could selectively structure protocols and other technical characteristics of communications service to favor its own data processing service offerings. Because of its enormous monopoly sector revenues, AT&T could, through cross-subsidization, win almost any competitive battle with a data processor. In short, AT&T could use its government-conferred franchise to support its competitive endeavors in unregulated markets.

S.898 attempts to deregulate many facets of the telecommunications industry and would effectively remove the constraints of the 1956 Consent Decree, allowing AT&T to enter non-regulated markets such as the data processing services industry. Given AT&T's history of anticompetitive conduct, ADAPSO is at a loss to understand why the competitive safeguards afforded by the 1956 Consent Decree are being eliminated by S.898 without adequate substitutes. In fact, ADAPSO queries whether there is a basis in law for the executive or legislative branch to vacate a judicially imposed decree. It is equally puzzling why S.898 does not propose a more appropriate response to AT&T's past conduct. In this regard, I refer to divestiture.

In lieu of the Consent Decree and divestiture, S.898 proffers a singularly misnamed safeguard -- a "fully separated" affiliate. As defined by the bill, this subsidiary will unfortunately do little to prevent AT&T from abusing its position as the supplier of limited communications facilities. The separation to which this subsidiary is subject is not only incomplete, it is riddled with exceptions. More alarming, the separation provisions of the bill endorse a structure in which AT&T and its competitive affiliate will permanently remain less than fully separated.

The enactment of legislation such as S.898 should be deferred because of the proceedings now pending before the federal courts in which the antitrust implications of AT&T's structure and its past and present conduct are being considered.

The most significant of these, of course, is the government's ongoing suit against AT&T, in which it has alleged serious violations of the antitrust laws, and in which it has requested divestiture. The record in that case will be closed by the end of the year; a decision by the trial court can be expected shortly thereafter. At that time, Congress will have available a complete factual record, one that may suggest a course of action different from that proposed by S.898. Any Congressional restructuring of the Bell System before the trial court renders its decision will compromise the suit; it will also undoubtedly affect the court's willingness to prescribe the relief that might otherwise be required by the facts.

My company and others in ADAPSO share the view of the Justice Department that divestiture is the only completely satisfactory means of assuring that AT&T's entry into unregulated markets is not accompanied by anticompetitive abuse. Requiring AT&T to form a maximally separated subsidiary to enter such markets is another, albeit significantly less effective, alternative.

The entry of a regulated monopoly into a non-regulated competitive market in which no one firm has market dominance must be allowed only where safeguards exist to ensure that the regulated venture cannot utilize its monopolistic power to deter competition in the unregulated marketplace. In return for Consent Decree relief which would allow AT&T to enter unregulated markets, Bell should be willing to accept legislative safeguards which assure that competitive advantages gained by virtue of its regulated monopoly status are not carried over into the unregulated market areas.

I now would like to touch briefly on the inherent competitive flaws of the "fully separate subsidiary" approach of S.898 and to offer a possible alternative for AT&T's entry into non-regulated markets.

Since S.898 proposes joint sharing of many activities between the parent and the subsidiary, an unlimited potential exists for anticompetitive abuse through cross-subsidization. S.898 prohibits joint sales and marketing; however, the bill completely undermines the effectiveness of this prohibition by permitting joint institutional advertising. It would be impossible to place a price tag on the enormous competitive value of the Bell logo; the subsidiary will be licensed to use this logo without charges, an obvious occasion of cross-subsidization.

S.898 inexplicably permits joint ventures and partnerships by AT&T and its affiliate. Nothing could be more inconsistent with the concept of structural separation.

S.898 permits AT&T's affiliate to individually own transmission facilities. AT&T could allow relevant portions of its basic network transmission offerings to deteriorate slowly or become outdated, in order to force users to turn to its subsidiary for vital communications services.

Even if AT&T did not allow its network to deteriorate, it could simply refuse to offer new services. Then because the affiliate is permitted to provide its own private line network, users would be forced to turn to the affiliate for service. The affiliate would then have the opportunity to tie its competitive services and equipment to that access.

While the bill also prohibits AT&T and its affiliate from jointly owning other types of property, it permits and seems to encourage the joint use of such property. Although S.898 attempts to solve these problems through appropriate accounting procedures, the resources required to establish, implement and monitor such an activity would far exceed those which are currently required to regulate AT&T.

Along with cross-subsidization, AT&T could easily use its monopoly power in the regulated markets to engage in other anticompetitive practices. While the bill would prohibit AT&T from misusing valuable business information about its affiliate's competitors which it could put to anticompetitive ends, violations would be extremely difficult to enforce.

For example, AT&T has virtually complete knowledge of our industry's customer lists, business dealings and service requirements. When a data processor or private user orders a leased circuit from AT&T, AT&T is immediately advised, before the contract is signed, of the speed at which the line will be operated, the line conditioning that is needed, and the type of equipment that will be connected to the circuit. When a local loop is ordered, AT&T learns where the circuit terminates. With this very limited initial contact, AT&T learns all essential information about the structure of a data processor's networks and the active business requirements of the data processor's potential customers.

When a data processor or resale carrier reaches a certain size, it is assigned what is known as a national account manager. The time of the account manager and supporting personnel is dedicated to serving a specific account. The manager acts as though he were literally part of the customer's organization, learning all about the customer, its needs, its programs, and its services; helping solve any and all communications problems; helping the customer select the most economical facilities available; and handling orders for repairs, new circuits, and equipment. In several of ADAPSO members' centers, office space is provided for Bell operating companies' representatives who work full-time as if they were employed by those member companies.

As an example, one of our member companies has nearly 1,000 credit unions nationwide that depend upon that company for their data processing needs. Through a complex telecommunications network, each is linked to a large computer center. That network consists of AT&T's long lines and local telephone company loops, most of which are part of the Bell System. In order to service this customer base, the company must give AT&T the names and addresses of every customer, and with transaction monitoring, Bell knows which customers are large users and which are small users of the data processing services that the company provides. At one of its computer centers, office space is provided for an AT&T representative who reports to work daily just as if he were a company employee. His role at the site is essentially to assist the company in providing an acceptable level of service to these credit unions. It should be obvious that AT&T account representatives, such as the individual I have just described, know far more about our individual businesses than any of our competitors.

If AT&T is competing with data processors through a less than fully separated affiliate, misuse of this valuable business information would be difficult to prevent. There is nothing in S.898 which would penalize individual employee violations; the transfer of employees between parent and subsidiary and any natural bias toward AT&T held by its employees would create a perfect climate for informal infractions. Consequently, confidential business information about our industry's members could be put to anticompetitive ends by the subsidiary.

AT&T's underlying control over the basic network gives it other competitive advantages. The number of available leased circuits is finite and, under the best of circumstances, users expect a meaningful delay between the time a circuit is ordered and the time it is installed. If AT&T were competing with a data processor for the same customer, it could provide more prompt service to that user and gain a customer that it might otherwise lose.

Users also could be told that local loops or leased circuits would be unavailable for some time. They could then be led to believe that a circuit might be available if requested in conjunction with a multiple order, such as one that involved data processing or terminal equipment in addition to the basic circuit. In other words, AT&T could use its control over basic communications "building blocks" to induce users to select its competitive service. This is not an academic argument, but is considered a realistic threat to our industry's vitality.

One way in which the potential for anticompetitive abuses could be lessened would be to require outside minority or majority ownership of AT&T's separated affiliate. The subsidiary should have a sufficient number of stockholders to comply with the SEC reporting requirements applicable to publicly held corporations. In this regard, ADAPSO actively supported the amendment offered last week during mark-up of S.898 by the Senate Commerce Committee by Senator Ernest Hollings which would have required only 10% minority ownership of the separated subsidiary. This amendment lost by only one vote, indicating substantial support in the Committee for this position.

In addition to the protection afforded by public reporting and disclosure, outside ownership would be useful in preventing and policing inter-corporate self-dealing. For example, the FCC has required in several instances (e.g. CML Satellite Systems; Satellite Business Systems) that no party of the joint ventures would maintain _de facto_ control, thereby thwarting any party from discriminating against other market participants. Multiple ownership will help reduce the potential for the affiliate to compete unfairly because of the backing of any one of the participating owners.

Outside ownership of, at a minimum, 10% would tend to reduce the incentive of the subsidiary to act only in the economic interest of the parent. Not only would the subsidiary be forced to meet the reporting requirements of the SEC, but it would be legally obligated to act in the best interests of _all_ stockholders. The greater equity ownership of others, hopefully the less control AT&T can exert on the subsidiary.

Furthermore, to guard against anticompetitive financing by AT&T once the subsidiary is fully established, additional capital should be required to be obtained through independent financing. This requirement is not unique; the FCC, reasoning that a separate subsidiary should not have a favorable capital market position due to its relationship with its parent, has prohibited Comsat from endorsing the commercial paper of its subsidiary, Comsat General.

Additionally, the affiliate should be required to pay back over a reasonable period of time all initial capital advanced by AT&T.

In closing, Mr. Chairman, I wish to stress that neither ADAPSO nor its members are unalterably opposed to AT&T's entry into the computer services industry. We ask only that AT&T be required to compete fairly, and that it be restrained from using its regulated monopoly power and resources, and its control over the communications network, for anticompetitive ends. Divestiture is one solution; a maximally separated affiliate is another. Regrettably, S.898 provides for neither.

It is therefore the view of ADAPSO and its members that S.898 should not be enacted unless it is substantially modified to prevent the separate subsidiary from owning transmission facilities, engaging in joint ventures and partnerships with its parent, jointly using property and facilities and benefiting from the parent's marketing and applied research efforts.

Any policy established by Congress in the area of telecommunications needs to incorporate the principles of free market enterprise. Revoking the conditions of the 1956 Consent Decree, and allowing AT&T to enter unregulated markets such as the data processing services industry, creates an enormous potential for unfair competitive abuse. It is essential that AT&T's entry into these markets be accompanied by adequate safeguards to ensure continued competitive growth.

For all these compelling reasons, it is essential that this Committee with its special expertise in antitrust matters closely examine this legislation. Too much is at stake to allow S.898 to reach the Senate floor without improving those provisions which allow for abuse and exploitation by AT&T of its regulated monopoly status and resources in currently competitive markets.

Testimony of Edwin B. Spievack
General Counsel
North American Telephone Association

Mr. Chairman,

On behalf of the North American Telephone Association, I want to thank you for this opportunity to address the worrisome issues of monopoly concentration and vertical integration raised by S.898. As this Committee is aware, NATA represents independent manufacturers and distributors of voice telephone terminal equipment sold in competition with traditional telephone companies in the United States.

On July 16, 1981, the Senate Commerce Committee passed from its chambers a bill of singular perniciousness in the annals of legislation. One is tempted to characterize S.898 as the Bell Welfare Act because there is a sense in which the legislation transfers indescribable welfare benefits and payments to AT&T. Yet it is also a piece of tax legislation. It clothes a private corporation with the public power of taxation to fund its own trade and commerce, at incalculable cost to competition and to consumer interests in the benefits of competition. But, most particularly, S.898 must be viewed as the "Bellamerica Act." It confers a national franchise, singling AT&T out as the government's preferred instrument of international telecommunications trade policy, of domestic telecommunications, data processing and computer requirements, and of telecommunications and information services for national defense, security, and emergency.

As one might expect with such a magnanimous franchise, S.898 confers substantial antitrust immunity. The immunization is not explicit. It is inextricably woven through the fabric of the legislation, and into a legally approved structure for the Bell System.

At the threshold, S.898 changes traditional statutory and judicial measures of dominant monopoly power. Rather than basing the concept on a corporation's control of identified geographic and product markets, S.898 defines dominance only in terms of those carriers that provide regulated telecommunications services in a substantial percentage of the total markets for such services. The definition limits the application of monopoly power to AT&T. But having defined the power, instead of fencing it, the bill enlarges it.

Customer premises equipment and information services appear to be excluded from the umbrella of FCC authority to maintain regulation over carriers where conditions of effective competition do not exist. The nexus between carrier service and carrier control of these markets is seemingly disregarded, in what appears as a congressional will to bequeath a legacy of carrier dominance in the present and future development of those markets.

The vertically integrated structure of AT&T is authorized and approved for at least six years after the enactment. During that period, Bell product and information service research, development, manufacturing, merchandizing and distribution can be freely subsidized by local exchange ratepayers. Thereafter, it appears that AT&T can avoid separating its research, development and manufacturing functions simply by creating a wholesale supply house to sell products and services to unaffiliated firms at the same price, and on the same terms and conditions as they are sold to AT&T's so-called fully separated affiliate.

While it is frequently difficult to explain how AT&T's vertical integration functions from manufacturing through distribution, the implications for competition are easily described. The structure suppresses competition. It is organized and managed to automatically transfer research, development, manufacturing and marketing costs from competitive products and services to regulated local exchanges. The process is enormously profitable to AT&T, just as it is enormously detrimental to competition. By unburdening itself of product costs, Western Electric can run down the prices of equipment and at the same time, fix profits on a predetermined target. If profits run into trouble because costs retained by Western Electric are too high, more of those costs are simply assigned to the regulated sphere. The increase in operating costs to Bell regulated carriers, forces an incremental rise in the rate of return regulatory agencies must authorize. Consequently, all regulated carriers enter competitive markets without risk, fully able to wage price wars of limitless duration. Because there is no financial risk, and limitless profit, the preferred carrier products and services are artificially priced to adversely affect the cash liquidity of competitive suppliers, and to limit the growth in market shares that competitive suppliers might otherwise achieve.

S.898, like predecessor legislation, is supposed to deter the exercise of such monopoly power in the interest of promoting competitive market development in telecommunications. The chosen policy of deterrence is the separate subsidiary, formulated in the belief that if subsidies flows can be dammed at the border between a carrier's regulated and unregulated activities, all competitors will start from a fair footing, without prejudice or advantage to anyone.

Whether the theory is sound, the implementation is flawed. AT&T is opposed to the restraint, and has successfully avoided it. Instead of separation, S.898 permits AT&T to retain centralized control and management of the Bell System, intact. But more importantly, the legislation delegates to AT&T the power to move the pieces of its system about - like pieces in a jig-saw puzzle - to focus the power of cross-subsidization at places in its business whenever and wherever it is needed to maintain and control markets.

The separate affiliate, though supposedly insulated from the financial support of AT&T and the regulated carriers with which AT&T is affiliated, can nevertheless enter into contracts, joint ventures and partnerships with AT&T and affiliated entities of the Bell System. These arrangements provide for the sale and exchange of property, joint financing, the furnishing of goods, services and facilities used in common for regulated and unregulated business, and for the transfer of commonly used assets. Western Electric, in addition, can perform installation and maintenance services for the customer premises equipment marketed by the separated affiliate, even though Western itself is not separated and is sustained by the revenues of regulated services.

To assure that the costs of product development and information services will not translate into prices prohibitive to the maintenance of AT&T's traditional markets, or into prices antithetical to the growth of AT&T's new markets, the separate affiliate is guaranteed the availability of initial and future subsidies. At current levels of $3 billion annually, S.898 shifts yellow page directory advertising into the separate affiliate for customer premises equipment, data processing equipment and services and resale transmission facilities. But, if this subsidy, based on control of the regulated network, proves insufficient, AT&T is given the option of transferring all or part of the long distance network into the subsidiary, whether it remains subject to regulation or not.

Competition is destroyed by these measures. S.898 contains no real separation requirements except in the most cosmetic sense. To the extent that competition may be allowed to exist, the decision is not that of the legislation, but is consigned by the legislation to the regulated carrier industry.

In two areas related to these disingenuous separation "requirements," S.898 represents a radical departure from previous legislative proposals. These involve (1) international trade, and (2) national defense, security and emergency preparedness.

S.898 contains explicit provisions through which AT&T's entry into international trade is subsidized off the back of the local exchange ratepayer. The corporation is totally freed of the cosmetic necessity of separating its regulated and unregulated activities when conducting business in foreign telecommunications markets, even though that trade is explicitly deregulated. Therefore, profits from foreign trading activity can be maximized by the authority conferred to shift the related development, manufacturing, merchandising and distribution costs to regulated services. Concomitantly, U.S. domestic manufacturers unaffiliated with carriers are threatened by the potential displacement of their prior entry into foreign markets. S.898, with abundant clarity, authorizes AT&T to extend its domestic price war into emerging international trading markets, which AT&T's competitors - and not AT&T - created.

The other especially pernicious feature of S.898 is its decision to eliminate competitive bidding for telecommunications products and services by executive agencies of the United States government. This is an example of one of history's ironies: that a Republican administration under President Nixon opened up competitive bidding and that a Republican administration under President Reagan is now closing it out. S.898 confers power on the President to determine that the interests of national defense, security and emergency preparedness require that all telecommunications services, facilities and equipment shall be furnished to executive agencies of the United States exclusively by carriers. In such circumstances, the separation of regulated and unregulated activities - as illusive as those so-called requirements are - do not apply. Obviously, they could not apply. Flexibility is needed on both sides. The government must have the best products and services ratepayer subsidies can supply. But if the ratepayer burden becomes a political embarrassment, government acquisition costs must be high enough to sustain AT&T's "unregulated" international and domestic operations, to preserve the continuing financial integrity of the firm in capital markets of the United States.

The most significant changes wrought in AT&T's status by S.898 relates to lawfulness. S.898 converts previously unlawful conduct, if found, into lawful conduct impervious to legal challenge, no matter how destructive to consumer and competitive interests. It fulfills two of the main purposes of AT&T's legislative program. It legislatively eliminates the 1956 Consent Decree under which AT&T voluntarily agreed to withdraw from all markets other than those for telecommunications services subject to public regulation. But equally, if not more critical, it assures that the government's pending antitrust case against AT&T cannot jeopardize the central control and vertical structure of the Bell System as it now exists. S.898 is quite explicit about the subject. It requires that any research, development and manufacturing which is to be conducted exclusively through a separated affiliate of AT&T shall be "owned" by that affiliate. Therefore, any court decree ordering the divestiture of Bell Labs and Western Electric as unseparated affiliates of AT&T would only have the effect of accelerating the transfer of those entities to the so-called separate affiliate. In effect, a court ordered divestiture would merely telescope the six year transition plan established in the bill.

S.898 suffers numerous infirmities beyond those described. Contrary to the purposes declared in the bill, it is clearly intended to create results destructive of competition. Perhaps the best proof rests in the provision that expressly authorizes all unregulated carriers, defined as telephone companies having revenues of less than $100 million, to deny all interconnection rights for competitive telecommunications services and customer premises products two years after the enactment.

In short, if competitive industries have been successful, it is obvious they are now to be penalized for that success.

The Senate Commerce Committee's bill is suffused with issues bearing on questions of national competition and antitrust policy. The adequacy of separation requirements bears directly on the future viability of competition in telecommunications, and of competition in information services and products which mark the advent of a post-industrial society. Because that future is under attack, it is time to explode the myth that communications legislation is designed to promote competition, and to forthrightly face the question of whether, and to what extent, the future of information and telecommunications services is best served by monopoly concentration, or what the proper mix and balance of competitive and monopoly influences should be.

The decision to relieve AT&T from the constraints of the 1956 Consent Decree and from jeopardy of the pending government antitrust should be similarly addressed in the light of what is intended. It should not remain hidden behind a facade of antitrust saving clauses which have no legal meaning or effect. Congress cannot say the legislation is not intended to effect present or future antitrust litigation and, at the same time, say a fully separate affiliate of AT&T is required to "own" the research and manufacturing capacity for products it distributes. It takes no great legal mind to understand that a court cannot order the divestiture of what AT&T is legally required to own.

Mr. Chairman, speaking for the members of the North American Telephone Association, it is our hope that this Committee will intercede in redrafting S.898 to establish competitive fairness and balance. It is our hope that we may work with the staff of your Committee to cover all those provisions of S.898 which are in critical need of change so the promotion of competition will truly represent a policy of this Congress.

Thank you.

MONOPOLIZATION AND COMPETITION IN THE TELECOMMUNICATIONS INDUSTRY

WEDNESDAY, JULY 29, 1981

U.S. SENATE,
COMMITTEE ON THE JUDICIARY,
Washington, D.C.

The committee met, pursuant to notice, at 1:30 p.m., in room 2228, Dirksen Senate Office Building, Senator Specter (acting chairman of the committee) presiding.

Staff present: Marcy J. K. Tiffany, antitrust counsel and chief economist; W. Stephen Cannon, antitrust counsel, and Peter Chumbris, chief antitrust counsel.

OPENING STATEMENT OF SENATOR ARLEN SPECTER

Senator SPECTER [acting chairman]. The committee will come to order.

Good afternoon, ladies and gentlemen.

This is the fifth and final hearing in a series on monopolization and competition in the telecommunications industry being held before this Committee on the Judiciary.

Telecommunications play a vital role in the economy of our Nation. As we continue to become increasingly dependent on the prompt and accurate transmission of information, the efficient allocation of resources to and within the telecommunications industry will have ever greater impact.

For this reason it is vital that the Government and this committee confront the issues of monopolization and competition in this industry and make as certain as we can that everything is being done to assure healthy and vigorous competition.

We will be hearing today from several experts in the antitrust field and the field of telecommunications, including former Government officials and distinguished scholars.

We are pleased to have four panels with us this afternoon.

In accordance with the regular practice of the committee, we will make all statements which have been submitted a part of the record at the completion of the oral presentations of each panel.

We will ask that each witness summarize within the general framework of a maximum of 5 minutes and leave the time for questioning to the fullest extent possible.

As you may know, this afternoon is final passage of the tax bill which may cause some interruptions from time to time. Therefore, there is additional reason to move along as promptly as we can.

Final passage is scheduled for 3 o'clock. Under the existing procedures, that means that there may be quite a number of amendments which will come up at 3 o'clock if they have not been voted upon in advance, which could present some problems for our scheduling.

We will want to move through the essential parts of the testimony to be presented orally just as promptly as we can.

Our first witness is Mr. Charles Ferris, formerly Chairman of the Federal Communications Commission and now practicing law with the firm of Mintz, Levin, Cohn, Ferris, Glovsky, and Popeo.

Welcome, Mr. Ferris.

STATEMENT OF CHARLES D. FERRIS, LAW FIRM OF MINTZ, LEVIN, COHN, FERRIS, GLOVSKY, & POPEO, WASHINGTON, D.C.

Mr. FERRIS. Thank you, Mr. Chairman.

As you said, Mr. Chairman, I served as Chairman of the Federal Communications Commission between October 1977 and April 1981. Prior to that time, I served as General Counsel to the majority in the Senate and as General Counsel to the Speaker of the House of Representatives.

The views that I am expressing today are my own. I do not represent any clients regarding S. 898.

I appreciate the opportunity to appear before you, Mr. Chairman, and members of the committee on this fascinating subject of competition in the telecommunications industry.

Only a decade ago, hearings on this subject necessarily would have been of limited interest, focusing only on certain types of equipment and channels used primarily by business. Today, however, the environment has changed dramatically.

The current policies embodied in FCC decisions, legislative statements of principle, and executive branch policy statements manifest wide agreement on the commitment to purge the entire range of telecommunications services and products of anticompetitive restrictions on entry and output.

This commitment in great part is reflected in the success of the American technology-intensive electronics industries over the past three decades. The resulting intelligence explosion is moving the country from the world's greatest producer of goods to the world's greatest handler of information.

The electronics revolution is rewriting the rules of the communications industry as well. For the first 60 years of the 20th century, communications meant telephone calls from one person to another. With the advent of affordable computing power, this concept changed in two synergistic ways.

First, computers had to receive the information to be processed from one distant point and produce the results in a useable form, normally at another distant point. This required the development of a capacity tailored to data transmission. Second, the integration of computers into communications hardware significantly enhanced the standard functions of transmission, switching and termination.

These two developments, in turn, dramatically altered the economics of providing communications services and equipment.

For the first time, specialization in this market had an economic value. Entrepreneurs discovered that the new technologies made it possible to earn an adequate return by customizing communications service to developing markets. The equipment necessary to offer these services was available.

This trend began in the 1950's and 1960's with the first FCC decisions allowing customers to attach equipment of their own choosing to the end of the telephone lines and giving corporations the right to create radio systems transmitting intracorporate communications between and among company offices. Since that time, FCC decisions have essentially eliminated all restrictions on new entry by communications service suppliers—both those that own their own facilities and those that resell the facilities and services of others—and equipment manufacturer and vendors. Unfortunately, Mr. Chairman, an FCC decision—or, indeed, a congressional decision—finding that the public's interest would be best served by a competitive market does not make that market competitive.

I believe this confusion of the abstract desirability of competition in communications with the existence of actual competition underlies the faulty premises of S. 898. As a result, I believe the bill jeopardizes the very competition it seeks to enhance.

Indeed, I believe that recent FCC policies, if upheld on review in the courts, will eliminate the vast majority of the unnecessary competition-inhibiting regulation that is the target of S. 898. This fact, Mr. Chairman, is a critical one, because it indicates an alternative legislative path to a competitive telecommunications market that does not contain the risks that S. 898 creates.

As I have mentioned previously, the communications industries are experiencing enormous changes in the technology by which their associated services are delivered. One of the more profound effects of these changes, in addition to those I referred to earlier, is that the business has become much more oriented to the demand of its customers than it ever was. Communications has become a demand-driven market.

This has important implications for the success of competition, because it rewards initiative and creates the necessary precondition for more ingenious suppliers to prosper. Absence of barriers to entry by new firms is a critical factor necessary to achieve this kind of competition.

Our policies at the FCC were designed to allow communications to become competitive. That is, we attempted to:

One, remove entry barriers so that new firms could readily enter the market.

Two, eliminate artificial restrictions on output.

Three, eliminate artificial product differentiation.

Four, increase the amount of information available to consumers.

I believe these actions were correct. Indeed, if the public is to be well-served by its communications industries, I believe they were necessary.

Mr. Chairman, I am the first to admit that wishing does not make it so. The FCC's policies, as important as I think they were, did not make communications competitive. Only private firms, risking valuable capital, can do that. We simply eliminated some of the more overt barriers to their incentives to do so. Unfortunately, many barriers remain.

While bigness may not necessarily be badness, it is not necessarily goodness either. One of the most formidable difficulties in the communications policy arena is that it is both. On the one hand, communications is a service whose value increases with the number of parties able to be reached. On the other hand, any potential entrant, even into a relatively narrow submarket, must be prepared to overcome the enormous presence of A.T. & T. already there.

More important, however, is that for more than 80 percent of the Nation's telephones, A.T. & T. is the gatekeeper by which its own competitors must pass. Not surprisingly, the gate frequently gets stuck. The leverage available to A.T. & T. by means of its integration of its long distance competitor with the local bottleneck monopolist is, in my mind, the single most significant factor in the structure of the telecommunications market today.

As this committee well knows, the antitrust laws have long been extremely concerned with the anticompetitive abuse of ownership of a facility necessary to the transaction of business in a given area. The history of competition in the telecommunications market is rife with instances where this bottleneck control has been employed for strategic purposes.

While complete denial of access to the essential local facilities has at times been enforced, it now seems clear that such a stark strategy is no longer sustainable. Rather, the currently preferred mode of bottleneck leveraging seems to be granting competitors access to the bottleneck but only on discriminatory terms.

Senator SPECTER. What is the answer to that problem, if there is one, Mr. Ferris?

Mr. FERRIS. The access problems?

Senator SPECTER. The bottleneck access problems.

Mr. FERRIS. What we did at the FCC is to commence the process of making the terms of access and the costs of access public.

That is an interesting example that I have given here. The very fact that the FCC sponsored all the competitors to sit down and see if they could jointly come up with a uniform charge to determine access, in and of itself, is a fascinating concept particularly that not only was it tolerated by the FCC but it was in a sense being sponsored by the FCC.

I think it is a sad commentary on the degree of competition in this particular market.

Senator SPECTER. What was the result of your efforts there?

Mr. FERRIS. The process is still going on. It is in the third iteration now, Mr. Chairman. They have not come up with a final access charge.

S. 898 sets up a procedure for access charges which I think is defective.

Senator SPECTER. In what respect?

Mr. FERRIS. The present process sets up under the Communications Act a joint board for these determinations. The joint board is made up of three members of the FCC and four members of State regulatory commissions. If the chairman of the FCC is one of the three members, he or she automatically becomes the chairman of the joint board. Although the FCC is in the minority with respect to the number of participants, its recommendations at that joint board go to the FCC for fiscal approval. The joint board acts in an advisory capacity.

The FCC takes those recommendations, and then makes a determination as to the validity of the judgment. It can modify those judgments.

S. 898 not only sets up a body consisting of four members of the State regulatory commissions and three of the FCC, but it makes their judgments final judgments. There is no effective review of that process by the FCC either on the merits or from the point of assessing the desirability of implementing and integrating those policy judgments into a uniform national communications policy.

I think that is just one element of what S. 898 does to the status quo which I think is a regressive step if what one is trying to do is foster the market forces that are at work or attempting to bring to bear a different type of chemistry in telecommunications.

Senator SPECTER. You testified last year that the 1956 consent decree allowed sufficient flexibility to pursue deregulation policies. Do you adhere to that view today?

Mr. FERRIS. Yes; I certainly do.

I think the interpretation that we put on the 1956 consent decree in the *Computer Inquiry II* demonstrated that we believed very much that even under the consent decree we could adapt to the present environment, which is far more competitive than it was in 1956, and permit A.T. & T. to participate in the new information services. Our decission amounted to an abandonment of what heretofore had been thought to be the only remedy that was available, which was to keep A.T. & T. out completely from the new information and enhanced services.

What we did was interpret the consent decree. I think it is a very valid interpretation. I think we will finally get an affirmation of that by the court that has jurisdiction in New Jersey.

Under the terms of the consent decree, A.T. & T., as you recall, Mr. Chairman, agreed not to participate in any business that was not subject to regulation.

What we did in the *Computer Inquiry II* was prescribe the terms and conditions of a separate subsidiary and prescribe the layers of insulation that would be required between the parent Bell and the separate subsidiary.

We at the FCC said that we were going, on a continuing basis, to monitor those degrees of insulation between the parent and the subsidiary and prescribe as need be and as markets developed and as historical data developed, adding any further degrees of insulation to assure the separation between those two entities. That was going to be how we at the FCC were going to exercise our regulatory functions.

Senator SPECTER. What constitutes those degrees of insulation.

Mr. FERRIS. The degrees of insulation that were prescribed included restrictions on the common ownership and common management between the parent and the subsidiary.

Probably the most significant one that is being overturned completely in S. 898, and which I think is a fatal flaw in S. 898, is the determination that the subsidiary could not own transmission facilities of its own or offer the same types of basic service being offered by Ma Ball—the parent Bell.

The subsidiary will be required to get its basic transmission capacity, its basic pipeline capacity, from the parent Bell under a tariff offering the same terms and conditions as are available to any of its competitors. That was a way to assure that the subsidiary was at least getting the communication pipeline on the same terms and conditions and not in a subsidized way so as to be able to get an unfair advantage over its competitors in the new information service area.

That is something that S. 898 overturns and explicitly permits the subsidiary to have the transmission capacity of its own.

I think that will have not only the effect of potential cross-subsidization but I think that the incentives will be for A.T. & T. very possibly to put all the enhancements and modernization of transmission facilities nationally into the subsidiary where it will be not regulated and permit the basic transmission pipeline and network of the parent to deteriorate.

I fear that over a period of time the natural evolution under the terms and conditions of S. 898 you will have a situation of everything important being in the subsidiary rather than in the network. In any event, I am afraid that this provision will destroy any competitive environment in the new information service.

Senator SPECTER. Thank you very much, Mr. Ferris. We very much appreciate your being here.

We turn now to Mr. Shenefield who was Assistant Attorney General for the Antitrust Division, Department of Justice, from 1977 until 1979, and Associate Attorney General from 1979 until 1981.

He now practices law with Milbank, Tweed, Hadley and McCloy.

Welcome, Mr. Shenefield.

STATEMENT OF JOHN H. SHENEFIELD, WASHINGTON, D.C.

Mr. SHENEFIELD. Thank you, Senator Specter.

Let me briefly summarize my statement.

I begin my recounting what I feel is an amazing history of success in the deregulation of industries that have led to benefits for consumers in the form of lower prices and better products.

From that experience and the studies that we are able to do as a result of them, we learn a few lessons, it seems to me.

One of them is that in all cases of doubt, we should have a presumption in favor of the competitive rule.

Second, where a single entity is to be deregulated, the presumption is that competition can work.

Third, where it is to be engaged both in regulated and free or unregulated markets, the nature of the filter—the manner of monitoring relationships between the regulated and the unregulated parts of the company—is of utmost concern.

That seems to me, therefore, to put in high relief the single critical question that emerges from a look at the telecommunications industry, the answer to which distinguishes that industry from all the other industries, in which deregulation efforts have gone forward.

That is, what is the shape of the industry and what can we say about the role of A.T. & T.

You may know that in trucking, some 15,000 separate trucking firms exist in this country. In airlines, I think it is accurate to say that the largest domestic airline has something like 23 or 24 percent of the market share.

Sharply in contrast to that situation, however, is telecommunications in which A.T. & T. is quite simply the dominant firm—a dominant firm across a variety of markets.

That fact of dominance alerts us to a major danger. That major danger, of course, is that the dominant firm will find ways to use the dominance in one market to compete unfairly in others.

After looking at that, the testimony I have given raises two or three important questions.

First, what are we to make of the Government's case against *United States* v. *A.T. & T*? How does that fit? Does it fit well with the legislative process?

My conclusion on that is that it is absolutely essential that that case go forward to conclusion, whether or not S. 898 is passed.

On the assumption that there will be a finding of liability, first of all, the judge will either order injunctive relief to govern the conduct or will order structural relief.

Senator SPECTER. When you say "a finding of liability," could you amplify that?

Mr. SHENEFIELD. I was posing alternative hypotheticals on the assumption that the court concludes that A.T. & T. is found to be liable for violation under the antitrust laws.

The court will, I presume, first look at the question of whether conduct-oriented injunctions or remedies will be sufficient to deal with the competitive problem and restore competition. If it concludes that that is insufficient, it will then look at the question of structural relief, a far more extreme measure obviously.

In either event, the enactment of S. 898, placing various portions of what we currently know as the A.T. & T. operation into fully separate affiliates, will not be a barrier to the court's moving ahead. Indeed, the legislation, as it is currently drafted, speaks in absolutely crystal clear terms on the subject.

There has been a great deal of comment, which I think you know, Senator, that the legislation in some way will muddy the area and that there will be a danger to the case. The judge will be affected and will be less likely to order, for instance, structural relief should it otherwise commend itself to him.

My own view is that a lucid judge, reading the language, will decide the case exactly as he should on the merits. Of course, he will be affected by the change in the landscape in the industry created by this legislation. There is no reason he should not be. He will not be affected, it seems to me, by virtue of the fact that the legislation has gone so far but no further than the fully separate affiliate concept.

If he decides that full divestiture is appropriate, my own view is that he clearly will go ahead.

Senator SPECTER. What would full divestiture entail? What would it mean?

Mr. SHENEFIELD. I do not propose to speculate in detail about it, but it does seem to me that one logical possibility is that he might decide that three separate portions of A.T. & T. ought to be split off from one another—the local operating companies, long lines, and Western Electric.

If he concludes that there are problems of cross-subsidy and there are problems of manipulation of cost allocations and the rest, he might decide that there ought to be a spinoff to stockholders of some or all of those portions. That is just one possible scenario.

I am not familiar with the way the evidence has gone into the record recently. I do not suggest that that is necessarily the right result.

It is important, I think, for everyone to realize that the case is not inconsistent with the legislation. The case stands on its own footing, and the case ought to go forward.

Senator SPECTER. Is the legislation perhaps inconsistent with the case?

Mr. SHENEFIELD. I do not believe so.

If divestiture ultimately is ordered, the fully separated affiliate concept is simply a step in that direction.

If the Government does not prevail in the case, the legislation represents Congress best view as to what the ideal form of the industry ought to be at this time.

It seems to me it is well to think of those two efforts as being able quite consistently to proceed apace.

Then you get to the next question, which is how do you deregulate if it is desirable? If you are not going to wait for the court to come to its conclusion, what do you do?

Two major things in this legislation both raise serious problems. One is the 1956 consent decree. The other is the establishment of the fully separated affiliate.

I begin my brief discussion of the consent decree with a passing reference to a series of constitutional arguments that have been made about the action of Congress.

Beginning on page 16, I try to deal in a relatively brief fashion with the argument based on the Constitution that it is simply inappropriate for the Congress to enact legislation that purports to deal with a consent decree.

On balance, after looking at the cases, it seems to me that argument is probably not well taken. If Congress can deal with the underlying legislation and if it can create an exemption for this company, it can probably alter prospectively a consent decree.

To come to the other conclusion, it would seem to me, would exalt form over substance. I cite, to confirm that conclusion, a variety of cases—some of them quite elderly I have to admit—but nevertheless persuasive.

My own conclusion, therefore, as the result of looking at the larger picture, is that legislation is desirable, in preference to the other means of opening up the markets—for instance, the reconstruction of the decree by the decree court in New Jersey and the *Computer Inquiry II,* together with the FCC's then interpretation of the decree, under Chairman Ferris' leadership. I presume it still has the same view of the words of the decree.

In preference to those two, legislation strikes me as the more direct, the more efficient and the more straightforward and probably less subject to litigating challenge over a long period of time.

Therefore, moving to the question of the fully separated affiliate point, I conclude that that is where the focus of discussion ought to be most intensive. It is by far the most troublesome aspect of the legislation.

I have concerns on a number of grounds about this affiliate concept.

First, the bill presumes that so long as the relationships between the affiliate and the parent can be made transparent, in general, the regulatory agency can monitor those relationships and insure that there is no undue favoritism.

Even assuming that is a relevant point, I do not think that the FCC as currently composed with its limited resources and its existing power—and I certainly do not think that the FCC after what this bill does to its authority is changed—can hope to keep up with the problem of allocation of costs across the number of markets and across the wide range of activities that this bill assumes.

Second, even if it can, the way we operate, in a regulatory context, the lag is such that for a small company driven out of business by anticompetitive conduct, the fact that a court of appeals sustains an FCC decision on finding of unlawfulness 8 years later is of small comfort.

I am concerned most fundamentally, however, that the bill and the concept of a fully separated affiliate does very little to change what I conceive to be the major problem, which is the underlying incentives.

I do not mean that A.T. & T. in any way is acting inappropriately. It is simply responding to what it views as its best business interest. Its own interest will be to try to suppress such competition as exists and maintain its own monopolies.

The bill does very little to correct those incentives.

It may well be——

Senator SPECTER. What can be done to correct those incentives?

Mr. SHENEFIELD. The clearest thing that could be done, assuming that there is a basis for it, is divestiture. That is obviously the clearest and cleanest and surgically complete measure.

Senator SPECTER. Why not go that route? What are the best arguments in your judgment against going that route?

Mr. SHENEFIELD. Assuming that one is czar and can order anything one wants, as of now, there is no legal——

Senator SPECTER. The Congress is not czar, but it can do that.

Mr. SHENEFIELD. It does not seem quite prepared to confront, if I may say so, divestiture at this point.

In H.R. 13015 2 or 3 years ago, the concept was raised. I think it gathered almost no support.

Senator SPECTER. It is a strong remedy for the Congress as well as for a czar. What are the best arguments in your judgment against it?

Mr. SHENEFIELD. Against divestiture, assuming that Congress were willing to take the step?

I think the main and perhaps dispositive argument is that with divestiture, though in theory you correct problems of economic incentives, you leap off into an unknown in the area of efficiencies and economy of the system as a whole. You simply do not know. We all have views and beliefs, but we simply do not know for sure precisely what will result from divestiture.

I think that is perhaps the strongest argument against it.

Senator **Specter**. It may be very strong to tell a company how to organize or reorganize itself, given the freedom of the company to organize itself as it chooses. However, you raise the strongest argument being inefficiencies in the company's operation with divestiture. I do not know that that should be the paramount concern of the Congress when facing a real concern about monopolization practices or about manipulation.

In looking at the problem, there is a tremendous number of evils and tremendous potential evils. There are tremendous numbers of uncertainties.

Mr. **Shenefield**. I agree with that.

Senator **Specter**. Is there any more extreme remedy than divestiture?

Mr. **Shenefield**. No. Divestiture is capital punishment as far as some business organizations are concerned.

Senator **Specter**. It is sort of like a starfish—it will continue to live.

Mr. **Shenefield**. I suggested only inefficiencies or potential for inefficiencies as the strongest argument. It does not seem to me at all that it is dispositive.

It is the argument that in an industry in which efficiency, innovation, and reliability are so crucial, you simply ought not to jeopardize those important economic values in favor of what I assume A.T. & T. would regard as somewhat more academic theories of efficiency in the long run.

My own view, as you may know, is that if the court in the case makes a finding of liability and decides that it is the incentives it has to deal with and correct, then in the tradition of the monopolization cases of this century, it will order divestiture. That is my own view.

Senator **Specter**. Do you believe that S. 898 falls within the scope of the authority you cite, since it does not modify the underlying antitrust law but just the consent decree alone?

Mr. **Shenefield**. You are talking about this consent decree?

Senator **Specter**. Yes.

Mr. **Shenefield**. I do. I think it survives the constitutional challenge.

Senator **Specter**. Assistant Attorney General Baxter wrote David Stockman on May 27, 1981, saying:

> In addition, we believe that although adoption of S. 898 should have no legal effect on the Government's position in *U.S.* v. *A.T. & T.*, it will as a practical matter seriously diminish the likelihood that the trial court will be willing if the Government prevails to award effective structural relief.

Do you disagree with Mr. Baxter?

Mr. **Shenefield**. I guess I think it is a little bit more of an institutional view perhaps.

Senator **Specter**. Whose institution?

Mr. **Shenefield**. The Antitrust Division. It is a very strong institution; it is very tightly knit. It has strong views.

Senator **Specter**. They would prefer to be unaffected. They would prefer to go ahead with their litigation without any congressional——

Mr. **Shenefield**. Sure.

They know they are going to get arguments from the defendant, regardless of what the bill says. They are going to get a lot of briefs that say: This issue has already been disposed of. It is in the legislative history that this legislation is inconsistent with the case. Therefore, we move to dismiss the case.

Then they are going to get it at every procedural stage between there and the Supreme Court. It will necessitate a lot of brief writing.

A.T. & T. is extremely militant in defending against the Government's prosecution in that case.

This is one argument they would rather not have to deal with. I think that is fair to say.

If I may, in concluding, Senator, what I would prefer to see done, if I were a voting Member of this body, is to give a chance first to the case. Second, confine this new concept of fully separated affiliates to one or maybe at the most two markets—markets in which the chance for competition is the greatest, rather than simply opening every market.

I think the potential for what has been called remonopolization because of the inability of the FCC to monitor and the incentives not having been corrected is simply too great across the board.

If it is to be all or nothing, if we have to have this bill or nothing at all, I come down in favor of the bill simply because I do not think we can stand—we, as commentators on this industry—in the way of technological progress.

Senator **Specter**. Do you think that the bill S. 898 will ultimately produce more or less regulation?

Mr. **Shenefield**. I think it will produce more regulations—certainly in the short run.

Senator **Specter**. And in the long run?

Mr. **Shenefield**. I do not know. In the long run, we are all dead. I am not quite sure when we get to the long run.

My concern is that for the foreseeable future, the FCC is going to need a lot more accountants and a lot more laywers and investigators to see how this bill is actually operating.

Senator **Specter**. Thank you very much, Mr. Shenefield.

Mr. Ferris and Mr. Shenefield, we appreciate your being here.

One of the things that I have found in my short tenure here is that these hearings are arranged necessarily with more than can be digested. Having the kinds of experts we have here, we hardly give the full range of inquiry—let alone in any respect.

We very much appreciate your being here and for your very comprehensive statements.

Mr. **Shenefield**. Thank you.

Mr. **Ferris**. Thank you.

[Material follows:]

PREPARED STATEMENT OF CHARLES D. FERRIS

My name is Charles D. Ferris. I served as Chairman of the Federal Communications Commission between October, 1977 and April, 1981. Prior to that I served as General Counsel to the Majority Leader of the U. S. Senate and the Speaker of the House of Representatives. I am now a member of the law firm of Mintz, Levin, Cohn, Ferris, Glovsky and Popeo. The views I am expressing today are my own and I do not represent any clients regarding S.898.

I appreciate the opportunity to appear before you, Mr. Chairman, to discuss the topic of "Competition in the Telecommunications Industry." Only a decade ago, hearings on this subject necessarily would have been of limited interest, focusing only to certain types of equipment and channels used primarily by business. Today, on the other hand, this subject is of enormous interest and importance to our national and international economy and to the full participation of all Americans in the future competitive communications market. Current policy, embodied in FCC decisions, legislative statements of principle, and Executive Branch policy statements, manifests wide agreement on the committment to purge the entire range of telecommunications services and products of anticompetitive restrictions on entry and output.

This commitment is in great part reflected in the success of the American technology-intensive electronics industries over the past three decades. For example, the first machine to bear the name computer -- the ENIAC -- was developed during World War II to make ballistics calculations. It required an entire room to contain its various noisy parts. Today, the computing power of the ENIAC could be dwarfed by a chip the size of a fingernail.

The ENIAC preceded the development in 1947 of the transistor and worked with vacuum tubes. The transistor itself has now been superceded by integrated circuits, which in turn have led to large scale integrated circuits (LSI) and to the current very large scale integrated circuits.

To describe this progression in cost terms, former Rand physicist Walter Baer has estimated that the costs of information processing and storage units have fallen by a factor of three every two years for the past twenty years -- a total cost decrease of more than 10,000 fold. The size of these units has also shrunk by a factor of 10,000, while their speed has increased at five times that rate. Thus, for about $100, each of us today can have computing power that would have cost several million dollars in the mid-1950's.

This intelligence explosion has had more profound consequences than the ubiquitous and apparently addictive video games now overunning the nation. It is changing America's work force from blue to white collar. It is changing the way our children learn, read and entertain themselves. It is moving the country from the world's greatest producer of goods to the world's greatest handler of information.

The electronics revolution is rewriting the rules of the communications industry as well. For the first sixty years of the twentieth century, communications meant telephone calls from one person to another. With the advent of affordable computing power, this concept changed in two synergistic ways. First, computers had to receive the information to be processed from one distant point and produce the results in a useable form, normally at another distant point. This required the development of a capacity tailored to data transmission. Second, the integration of computers into communications hardware significantly enhanced the standard functions of transmission, switching and termination.

These two developments, in turn, dramatically altered the economics of providing communications services and equipment.

For the first time, specialization in this market had an economic value. Entrepreneurs discovered that the new technologies made it possible to earn an adequate return by customizing communications service to developing markets. And the equipment necessary to offer these services was available.

This trend began in the fifties and sixties with the first FCC decisions allowing customers to attach equipment of their own choosing to the end of their telephone lines and giving corporations the right to create radio systems transmitting intracorporate communications between and among company offices. Since that time, FCC decisions have essentially eliminated all restrictions on new entry by communications service suppliers -- both those that own their own facilities and those that resell the facilities and services of others -- and equipment manufacturers and vendors.

Unfortunately, Mr. Chairman, an FCC decision -- or indeed, a Congressional decision -- finding that the public's interest would be best served by a competitive market does not make that market competitive. I believe this confusion of the abstract desirability of competition in communications with the existence of actual competition underlies the premises of S.898. As a result, I believe the bill jeopardizes the very competition which it seeks to enhance.

Before commenting specifically on S.898, I believe it might be useful to summarize my understanding of the present state of the communications market. For the last four years, I have been extensively involved in the FCC studies of this market. Based on these studies, the FCC took certain actions to further competition and eliminate unnecessary regulation. An explanation of these actions may be helpful to the Congressional dialogue on these critical issues.

The Commission's policies under my chairmanship were firmly deregulatory. Indeed, I believe our policies, if upheld on review, will eliminate the vast majority of the unnecessary, competition-inhibiting regulation that is the target of S.898. This fact is a critical one, Mr. Chairman, because it indicates an alternative legislative path to a competitive telecommunications market that does not contain the risks that S.898 creates.

As I have mentioned previously, the communications industries are experiencing enormous changes in the technology by which their associated services are delivered. One of the more profound effects of these changes, in addition to those I referred to earlier, is that the business has become much more oriented to the demand of its customers than it ever was. Communications has become a demand driven market. This has important implications for the success of competition, because it rewards initiative and creates the necessary precondition for more ingenious suppliers to prosper.

At present, FCC decisions have authorized the entry of new competitors into all segments of telecommunications. These new firms employ both terrestrial and satellite facilities. Some own no facilities at all, but rather lease capacity from other carriers and resell that capacity -- either with some value added by means of computers, or at a lower price -- to third parties.

Equipment manufacturers, particularly those dealing in so-called terminal equipment, have been assured by FCC rule that so long as their products operate in conformance with minimum technical standards, telephone companies cannot restrict their use by customers.

The Commission has recently eliminated some excessively burdensome paperwork requirements for companies without market power that wish to alter their markets or prices. It has proposed to simplify AT&T's tariff structure so that individual services, and their component functions, are described in a manner readily understood by consumers. This will allow users to make rational choices among competing services. The Commission has ordered the telephone companies to eliminate their restrictions on the way customers may use services they take under tariff. The elimination of these restrictions has caused, and will continue to cause, new entry by firms leasing capacity from carriers while at the same time policing the prices of carriers to assure they are non-discriminatory.

Economists tell us that an industry is competitive when, in the sale of a homogeneous commodity, no individual firm can influence the commodity's price by varying the quantity of output that it sells. Absence of barriers to entry by new firms is a critical factor necessary to achieve this kind of competition. Our policies at the FCC were designed to allow communications to become competitive. That is, we attempted to (1) remove entry barriers so that new firms could readily enter the market, (2) eliminate artificial restrictions on output, (3) eliminate artificial product differentiation, and (4) increase the amount of information available to consumers.

I believe these actions were correct. Indeed, if the public is to be well served by its communications industries, I believe they were necessary. But, Mr. Chairman, I am the first to admit that wishing doesn't make it so. The FCC's policies, as important as I think they were, did not make communications competitive. Only private firms, risking valuable capital, can do that. We simply eliminated some of the more overt barriers to their incentives to do so.

Unfortunately, many barriers remain. While bigness may not necessarily be badness, it is not necessarily goodness either. One of the most formidable difficulties in the communications policy arena, is that it is both. On the one hand, communications is a service whose value increases with the number of parties able to be reached. On the other hand, any potential entrant, even into a relatively narrow submarket, must be prepared to overcome the enormous presence of AT&T already there. To illustrate this point, in a capital intensive industry like communications services, AT&T's $135 billion network, being supplemented by over $15 billion in new construction annually is a formidable deterrent to such competitors. In 1977, AT&T alone accounted for nearly four percent of the assets of all nonfinancial corporations. Its workforce exceeds the population of 13 states and was about as large as the industrial labor force of Austria, Switzerland or Denmark.

As a practical matter, the telephone companies investment decisions in their plant are basically beyond the review of any regulatory authority. In 1979, for example, AT&T spent $16 billion on new construction. The FCC was authorized to review only $100 million of this. Although empowered to do so by Section 214, as far as I can tell the Commission has never orderd AT&T to remove imprudently spent investment from its rate base nor to invest in the construction of any new facilities. Effective regulation of the dominant carrier requires the correction of this glaring impotence with respect to billions of dollars of annual investment.

More important, however, is that for more than 80% of the nation's telephones, AT&T is the gatekeeper by which its own competitors must pass. Not surprisingly, the gate frequently gets stuck. The leverage available to AT&T by means of its integration of its long distance competitor with the local bottleneck monopolist is, in my mind, the single most significant factor in the structure of the telecommunications market today. As this Committee well knows, the antitrust laws have long been extremely concerned with the anticompetitive abuse of ownership of a facility necessary to the transaction of business in a given area. In cases dealing with bottleneck facilities, from railroad terminals to press associations to electric power distribution, the Supreme Court has refused to tolerate attempts to gain competitive advantage through exploitation of the power inherent in control of an essential facility.

The history of competition in the telecommunications market is rife with instances where this bottleneck control has been employed for strategic purposes. While complete denial of access to the essential local facilities has at times been enforced, it now seems clear that such a stark strategy is no longer sustainable. Rather, the currently preferred mode of bottleneck leveraging seems to be granting competitors access to the bottleneck, but only on discriminatory terms.

An examination of each identifiable class of competitor, from the first terminal equipment manufacturer to the latest information service, shows the anti-competitive impact of unequal access. Today, for example, the Commission is presiding over the third round of negotiations among competitive carriers to arrive at fair and justly priced interconnection. As a practical matter, I think these negotiations among competitors to set prices, terms and conditions of service are probably necessary at this time. But the very fact that the FCC would tolerate, never mind sponsor, meetings which would be considered the antithesis of competition in any other industry, indicates the extent of the problem.

These competing common carriers, having been authorized by the FCC to provide certain services to the public, find that AT&T's interconnection format requires an OCC customer to dial twice as many numbers to place a call over its system that interconnects with the AT&T network than the same customer would be required to dial if it selected the higher priced AT&T services. Even then, the interconnection is technically inferior, in that it is two wire vs. four wire for AT&T. MCI, has recently announced an agreement with the Northwest Iowa Telephone Company, a small independent telephone company, that provides interconnection of the same type of facilities, used to offer the same services, by dialing only one number. Only a few days ago, AT&T itself sought special permission from the FCC to file a tariff that, among other things, would offer competing carriers a limited form of so-called "trunk side" interconnection. Given these very recent developments, one wonders how past discriminatory access to AT&T's local facilities can be justified? How many customers were denied the benefit of choosing among competing services by these tactics? I do not believe that any market can achieve competitive performance levels so long as exploitation of a facility necessary by all is permitted.

Other industry groups could relate instances of similar treatment. Private microwave systems, radio common carriers, miscellaneous common carriers, domestic satellite carriers, security alarm services, cable television systems -- each has had its access to the market denied, impeded or conditioned. Industries not yet fully in existence -- indeed which as a result may never come into existence -- are being subjected to similar treatment.

As the vaunted Information Age comes upon us, one of the earliest services of major significance to be produced is voice message systems, which involve computerized retention, storage, editing and retransmission of voice messages. Several independent vendors, including ECS Telecommunications, Delphi (an Exxon subsidiary) and others have announced products for this market. AT&T has recently announced its own voice message offering under the name Custom Calling II.

While the marketplace may detect other material differences, a major distinction between the Custom Calling II offering and the others is that AT&T has designed some of the competitive system's functions into its network switches. Competitors must equip their terminals with these functions separately. AT&T designed its system in this way, according to an affidavit of an ex-Bell Labs employee who worked on the project, and which is on file with the FCC, with the knowledge and intent of providing itself access that would be competitively superior than the access that it would afford its competitors.

The terms of access to the network facilities are only one element in the determination of the efficacy of interconnection. The price charged for whatever interconnection is provided is also an important factor in determining whether a competitive offering can be successful. At the present time, even before any possible increase in local distribution charges resulting from regulatory or legislative action, payments by competing carriers to AT&T for local access constitute their single largest expense.

No one would deny, I presume, that a person, whether corporate or individual, employing the local distribution facilities of a carrier should pay the costs imposed on the local carrier for rendering that service. The determination of those costs, however, is exceedingly complex. This complexity is further compounded by the claims and counterclaims of subsidies flowing to or from local service.

I do not pretend to be able to inform the Committee of the appropriate price for local access. I do believe that every class of user of local facilities, whether AT&T customers (including FX and CCSA subscribers), or customers of other carriers, should be required to bear their fair share. But what is clear is that whatever price is arrived at for these services will be of critical importance to the market's acceptance of any service on which it is imposed. The level and structure of any access charge will determine in large measure, I believe, the succes of a pro-competitive communication policy. As a result, I believe that the utmost care and attention should be paid to the calculation of access charges by the Congress, the Commission and by all the affected parties including consumer groups.

Mr. Chairman, I have focused on conduct in the telecommunications market because I believe that the last several decades have demonstrated patterns of conduct by the dominant carrier from which a certain wisdom can be derived. Conduct, of course, is not the only measure by which the soundness of future policies can be judged. Structural considerations also support the need for the exercise of care in fashioning policies for a competitive market for the future.

This Committee is well acquainted with market analysis and the market shares relied upon by courts to find market power. Market power, frequently defined as power over price, arises out of the distortion of an atomistically-structured market by one firm obtaining a dominant share of the business. This dominance, in turn, frees it from the position of a price-taker. Rather the dominant firm's output decisions can have an effect on the prices paid by purchasers from other suppliers.

The minimum market share necessary to bestow this power on a firm will vary from market to market depending on a variety of conditions. Economists have suggested that markets with a four firm concentration ratio of 40% have deviated far enough from a competitive structure to be classified as oligopolistic. Profit levels are almost always increased as a market reaches this level of concentration. While economies of scale may explain some of this higher profit, one major study concluded that the three leading firms in 12 industries studied were on average three times as large as would be required to capture almost all available economies (F. M. Scherer et al., The Economics of

Multi-Plant Operation: An International Comparisons Study, Harvard University Press, 1975, pp. 334-336). Market shares bestowing power over prices independent of cost savings were said to be a considerably more important factor in the profit levels of such firms (F. M. Scherer, Industrial Market Structure and Economic Performance, 2d. ed., Rand McNally College Publishing Company, 1980, p. 283).

The FCC has recently calculated some market share statistics which the Committee may find interesting against the backdrop of these general economic findings. According to the Commission's staff, total communications operating revenue in 1980 was $62.655 billion. All telephone companies received 99.2% of these revenues ($62.199 billion). Specialized Common Carrriers received .66% of these revenues ($415 million) while Miscellaneous Common Carriers received .07% ($41 million).

In the interexchange MTS submarket, based on the filings of some 68 telephone companies reporting, the FCC calculated a total 1980 operating revenue of $23.288 billion. Of this amount, the reporting telephone companies received 98.7% ($22.982 billion) while the specialized Common Carriers received 1.3% ($305 million). In the interexchange private line submarket, based on the same information base, total operating revenues amounted to $2.719 billion in 1980. Of this amount the telephone companies received 94.3% ($2.563 billion), the Specialized Common Carriers received 4.2% ($114 million) and the Miscellaneous Common Carriers received 1.5% ($40 million).

Mr. Chairman, I believe these telephone industry market shares of over 99%, 98% and 94% respectively, indicate beyond dispute the minimal extent to which competition in the telecommunications industry is now an effective regulator of firm conduct or performance. That is not to say that competition should not be supported. I believe it should be, and the FCC program over the last four years did so. Indeed, I believe deregulation of a significant portion of the telecommunications industry is justified now. In my opinion, what these market shares indicate is the absolute necessity of not proceeding with a program of deregulation in a way that leaves the public totally without recourse, either in the market or before the government.

In his famous dialogue, The Statesman, Plato said that laws that are adopted represent the fruit of experience. I believe that were S. 898 to become law, it would do so despite the experiences that I have reviewed here today. For experience in every industry in our economy tells us that market shares of over 90% held by single firms indicate a monopolist, that firms with monopoly control over essential facilities must be prevented from abusing that control, and that the price for, and terms and conditions of access to, local customers has been a major stumbling block for any new ventures attempting to enter the telecommunications industry. Experience also tells us that in communications specifically each of these dangers is present, and has already created distortions in the market. Yet S. 898 fails to account adequately for any of these lessons.

The FCC adopted several decisions in the recent past which, I believe, accommodated the interests of fostering competition, eliminating unnecessary regulatory restrictions and continuing to protect otherwise jeopardized vital public interests. These decisions were not as all-encompassing as the legislative proposals have been over the last several years. Yet where they do address similar issues, the policy represented in those FCC decisions differs in material respects from certain of the provisions of S. 898. I believe I can be more constructive in this important legislative process that the Congress has undertaken if I discuss the Bill in relation to these policies.

I agree wholeheartedly, Mr. Chairman, as I am sure every witness appearing before you does, that the entry of new firms into the communications markets has served the public well by offering products more closely responsive to consumer's demands at more attractive prices. I support the conclusion that the number and kinds of firms providing communications services has grown so diverse that a uniform system of regulation has become unfair and counterproductive. I agree also that the booming information industries have altered the kind of equipment and services demanded by consumers and that this alteration requires a corresponding change in the regulatory system applicable to the offering of those services and equipment. Furthermore, I agree that AT&T should not *a priori* be foreclosed from participating in these markets.

Let me address the latter point first because it is one of the most difficult public policy decisions involved in the current debate on the future of this industry. AT&T now consists of three vertically integrated components, equipment, local service, and long distance service. In essence, each part of AT&T is a monopolist in its submarket.

What the bill allows, and what the FCC also allowed in its *Computer Inquiry II* decision, is to permit AT&T to integrate further into the competitive information services business while remaining the dominant supplier of the channels necessary to conduct the information services business. Because of AT&T's dominant share of available transmission capacity, most data processing companies today, and the information service companies of tomorrow, will be dependent on AT&T for the provision of the communications capacity necessary to conduct their businesses. Moreover, AT&T will continue to control the essential access bottleneck that has been the ground of so much controversy in the past.

At the same time, AT&T will be an information services retailer itself, competing against firms dependent on it for transmission and access. AT&T's role under these circumstances places it in a perpetual conflict of interest. Yet foreclosing AT&T's entry into this new business is the most draconian form of economic regulation possible. Open entry is one of the touchstone principles for truly competitive markets. Keeping AT&T out of the information business would not only prevent consumers from receiving the benefits of a competitive application of its acknowledged expertise in these areas, but also would chill the force of competition by announcing a priori that a formidable potential foe is disqualified from challenging established firms.

I believe there is a compromise that allows an escape from this dilemma. Like all compromises, it does not overcome all the objections raised against either choice. But it does provide an acceptable solution to a difficult cost benefit calculus.

The FCC's solution to this issue is contained in the Computer Inquiry II decision. There, we required AT&T to establish a fully separated subsidiary for the provision of enhanced services and terminal equipment. This subsidiary would then be unregulated. We defined enhanced services as those that involve more than the simple transmission of unchanged information between two points, which are normally provided by combining computers with basic transmission "pipelines."

This subsidiary was prohibited, for the most part, from owning transmission facilities. This prohibition, a fundamental premise of our decision that would be reversed by S. 828, accomplishes several critical purposes.

First, ownership of facilities by the subsidiary necessarily involves it in the provision of basic telecommunications services. Because we did not believe that any of AT&T's offerings of these services were subject to effective competition, we did not propose to deregulate them. Thus, if allowed to provide basic transmission services, the subsidiary would be offering both regulated and unregulated services simultaneously. In turn, this would require the subsidiary to engage in the allocation of its costs between and among regulated and unregulated services.

The history of competition to date indicates very clearly the likelihood of cross-subsidization where cost allocation procedures of this kind are required. For this same reason, we required AT&T's network services to be exclusively basic, and regulated, and thus prohibited code and protocol conversion services being offered in the regulated network.

Our second reason for prohibiting the subsidiary from owning transmission facilities was that operating the subsidiary in the resale mode required AT&T to offer its network interconnection to the subsidiary as well as all other customers on equal non-discriminatory terms. Because the subsidiary's interconnection would be obtained under filed tariffs, violation of this requirement would violate the Communications Act. Any attempts by AT&T to give its subsidiary favorable treatment regarding access prices, terms or conditions would be more readily detectable.

Our third reason was that requiring AT&T's subsidiary to lease capacity gives the parent a stronger incentive to maintain the technological currency of the underlying network. In order to provide its subsidiary with the latest technology, AT&T would thus be stimulated to provide these same benefits to the general public. By this mechanism we were confident that the general body of ratepayers would not suffer as AT&T in effect abandoned the basic network in favor of modernizing the facilities of an unregulated subsidiary.

I believe these safeguards are absolutely required if competition in these markets is to be full and fair. The creation of a subsidiary is not the same as the divestiture of an enterprise. The incentives of either firm are therefore not different than they would have been absent the corporate reorganization. What is different is the reduction of their ability to engage in certain activities as readily as the increase in the ability of third parties to detect transgressions when they occur.

Let me stress that illegitimate allocations of costs and profits between the parent and the subsidiary are not foreclosed by this mechanism. Rather, it is designed simply to make it more difficult for the firm to engage in these activities without being caught. Indeed, because the subsidiary concept relies on accounting to some degree for its enforcement, it is not even clear that it will succeed at that. But without safeguards such as those we adopted in Computer Inquiry II, I do not believe the subsidiary has any meaningful prospect of succeeding.

The "fully separated affiliate(s)" called for in S. 898 falls far short of meeting these goals. By apparently allowing the subsidiary to own transmission facilities, the bill acquiesces to an undetectable scheme of cross-subsidization. Customers of the regulated services suffer by bearing the excessive costs necessary to sustain this scheme. Customers of the unregulated services suffer by having an otherwise competitive market structure distorted by artificially lowered prices. To the extent that the subsidiary becomes self-sufficient in transmission, other vendors suffer from the elimination of AT&T's incentive to provide service on equal terms and conditions at a cost-based price.

Section 227(b) of the bill permits a so-called "fully separated affiliate" to enter into any "contract, agreement, arrangement, joint venture, partnership or other manner of conducting business with its dominant-regulated carrier or any affiliate " so long as certain aspects of these "arrangements" are "fully auditable and compensatory." This provision alone would be sufficient to undermine the separate subsidiary as described in the bill. When this invitation tojoint dealing is combined with the other provisions I have mentioned, the rationale for the subsidiary concept as I have outlined it above becomes almost unrecognizable.

Because the bill allows a variety of enhanced and basic services to be offered through the "FSA," whether on a resale or facilities basis, it dramatically increases the risk that AT&T will abandon the regulated network's customers for the higher profits of the unregulated subsidiary. This problem is particularly exacerbated by the bill's lack of clarity regarding which services are to be offered by which entity.

In addition to these defects in the "FSA" structure outlined in S. 898, it appears that the "fully separated affiliate" will be permitted to be established with monopoly market shares in both the private line and terminal equipment markets. These market shares would be obtained by transfer of current business from AT&T to the FSA at its inception.

The procedures by which the capitalization of the subsidiary is to be accomplished provide no basis for confidence that such a result will not happen. An Asset Evaluation Board is created to determine the value of any assets transferred. Because AT&T has not maintained records of depreciation on a disaggregated basis, the determination of "value" will necessarily be somewhat arbitrary.

For example, developmental expenses for information services have been accumulated for several years and now total hundreds of millions of dollars. Are these expenses "assets" whose "value" is to be determined by the Board? The bill doesn't say. If not, are they to be left with the parent carrier for repayment by customers of regulated basic services? The bill doesn't say. Can the Commission order the expenses to be included in the capitalization of the subsidiary? The bill doesn't say. Yet there are simply no substantive or procedural safeguards specified in the bill to protect consumers or competitors from decisions on capitalization such as this one with the most profound implications for competition in the communications industry. It is not even clear whether the decisions of this Board, however they might be reached, are appealable, or to whom, or under what standard.

Mr. Chairman, the subsidiary specified in S. 898 no more resembles a structural compromise adequate to protect consumers from anticompetitive abuse than the shadows on the wall resemble reality in the famous Allegory of the Cave. It would be better to forswear such transparent devices which gain so little than to jeopardize meaningful judicial relief by altering structure by this modest amount.

As I have mentioned above, I believe the separate subsidiary should be barred from owning transmission facilities, should be barred from offering -- even on a resale basis -- currently available services in which AT&T has a dominant market share, and should be barred from engaging in joint ventures or partnerships with its parent. Moreover, I believe the amendment offered by Senator Hollings at the Commerce Committee mark-up, which required that the subsidiary be capitalized with some outside financing, would be a positive step. The Comptroller General made a similar suggestion before the House during its consideration of H. R. 6121. The presence of outside financing would add another element of accountability and scrutiny to the competitive market without materially infringing on the subsidiary's operations.

Furthermore, I do not believe the bill's structural safeguards provide an adequate basis for the modification of the

Consent Decree which S. 898 effects. That decree, entered into by AT&T and the government in a settlement of an earlier antitrust case, was predicated on a more homogeneous industry. In 1956, communications and regulated were co-extensive concepts, by and large. Today, that is no longer the case. Application of the decree in 1981 must continue to be in a context of safeguards adequate to protect consumers from the unchecked exercise of monopoly power the Decree was designed to prevent.

In the Computer Inquiry II, we stated that we believed the 1956 Consent Decree did not foreclose AT&T from participating in the provision of terminal equipment or enhanced services without filing of a tariff. This decision was, however,firmly predicated on our conclusion that the jurisdictional findings and structural protections we had required were the minimum necessary to fulfill the purpose of the Decree. This bill, on the contrary, vacates the Decree in substantial part but neither acknowledges nor resolves AT&T's continuing market power and the anti-competitive effects which result from it.

Another serious flaw in S. 898 is its sharp restriction on the authority of the FCC to correct any problems that might arise as the industry traverses the highly complicated transition period. As with the evaluation of assets transferred to the subsidiary, the critical communications policy matter of the specification of access charges is to be performed by a Joint Board, a majority of whose members will be state regulators. Unlike the current Act, S. 898 gives final authority to the Joint Board itself rather than the federal agency. Subsequent FCC review of the Joint Board's action is narrowly circumscribed. Even if the Commission should find the Joint Board's decision to be arbitrary or capricious, the bill specifies no procedures for any further action. This is a quagmire from which the fundamental issue of fair and equal prices for local access should have been extricated.

The FCC's continuing oversight responsibilities beyond the immediate transition period, also have been sharply curtailed by this bill. For example, the Commission may not establish requirements relating to the "structure or organization" of the Bell-affiliate. Where the Commission does have initial authority to review AT&T's plans, the schedules for agency action are so truncated that no meaningful analysis could possibly be undertaken. Moreover, the powers granted the Commission as part of its reviewing responsibilities are extremely ambiguous.

The provisions gutting the FCC's oversight powers regarding the newly created competitive Bell-affiliate are the legislative equivalent of a life jacket burning party by the passengers of the Titanic. The dangers of anticompetitive abuse are so real given S. 898's empty provisions that some prophylactic or corrective actions are certain to be needed. To strip the single agency with the most relevant experience of its ability to protect the public in any meaningful way is to give AT&T a quitclaim deed to the Information Age.

What few oversight powers are left by this bill to the FCC are based on expanded regulation of carrier conduct through accounting and auditing practices. These mechanisms have proven woefully inadequate in the past and as the technology and telecommunications system architectures become even more complicated, they are not likely to become the panacea the bill presumes. Every year AT&T engages in hundreds of millions of transactions with vendors, customers, employees and others. Short of replicating the corporate structure of the company itself, no outside agency can ever have confidence that a system of oversight dependent on data generated by the overseen will be valid. In fact, I do not believe that AT&T itself knows what is costs are and how they should be assigned. To expect the FCC to know more than the company itself is obviously a futile hope.

If I may, I would like to address one final point before closing my testimony today. There has been much discussion about the effect of this bill on the pending government antitrust suit against AT&T. I disagree with those who claim that passage of communications legislation will terminate this case. The Supreme Court has consistently stated that the antitrust laws continue to apply to regulated firms and that implied repeals are "strongly disfavored." As recently as this term, the Court in the National Gerimedical case reiterated that such repeals will only be accepted where "necessary to make the Act work," such as where there is an "irreconcilable difference" between the antitrust laws and regulatory statute. I do not think either the current law, or its proposed amendments, pose such a fundamental conflict.

However, I cannot believe that a statute that includes some structural modifications to AT&T, and represents the product of over five years of related Congressional consideration, will have no impact at all on the courts. I fear, without claiming any more expertise than the next observer, that the structural relief sought by the Government will be much harder to achieve once legislation is adopted.

Nevertheless, I still believe that the much needed certainty that legislation wll create for this market warrants the adoption of a good bill. But the threat that any structural modifications adopted in a bill will be the only real safeguards incorporated for the protection of the public requires that they be adequate to justify undermining the prospects of judicially ordered relief.

This trade off is one that will afflict any legislation involving the telecommunications industry. The antitrust laws represent a national commitment to a free and competitive economy. Communications legislation should do the same. It is only where the latter fails to achieve its purposes, as in the case of S. 898, that a significant threat to the enforcement of the antitrust laws is created.

As you well know, Mr. Chairman, your counterparts in the House agree with your assessment of the need for close scrutiny of this bill. Last year, a similar bill was reported out of the then House Committee on Interstate and Foreign Commerce. Because of the serious implications for competition which the bill entailed, the Speaker of the House ordered the bill sequentially referred to the Committee on the Judiciary. After hearings were held, the Subcommittee on Monopolies and Commercial Law, and then the full Committee, reported the bill adversely.

The Subcommittee concluded that an adverse report was required because the bill was "substantially flawed." Many of the infirmities the House Committee found in H. R. 6121 have been carried over in S. 898. Indeed, many are even more pronounced in the latter bill. This bill is substantially flawed, Mr. Chairman. Indeed, it is fatally flawed. But far more significant, I fear that if S. 898 is adopted the chances for a competitive telecommunications industry in this country will also become fatally flawed.

I would submit, Mr. Chairman, that the advent of a competitive telecommunications market is at some remove from the present. The nation as a whole has a great stake in having that day come as soon as possible. S. 898 jeopardizes the possibility of a competitive industry by removing regulatory and structural safeguards while there are inadequate market forces to police monopoly conduct. The predictable result is an Information Age slow in coming, excessively expensive, and full of errors.

I do not believe the American people can tolerate that result, Mr. Chairman, and therefore I commend you and the Committee for your close scrutiny and subsequent involvement wth this issue and this bill. I would be happy to help you in any way that you wish and to answer any questions you might have.

Thank you.

PREPARED STATEMENT OF JOHN H. SHENEFIELD

Mr. Chairman and members of the Committee, I am delighted once again to appear before you as a witness, this time to present my personal views in connection with the competition implications of S.898, the "Telecommunications Competition and Deregulation Act of 1981." My testimony applauds the deregulatory and pro-competitive purposes of the bill, but identifies issues that must be resolved before the bill is entitled to become national telecommunications policy. I conclude that, in any event, the government's antitrust case against AT&T must not be deflected, since its findings will provide an essential and irreplaceable part of the basic record upon which national telecommunications policy for the future must be based.

In recent years, we have seen a fundamental shift in U.S. domestic economic policy away from reliance on regulation and toward competition as the most efficient allocator of resources and guarantor of the best quality products at the lowest prices. The change has been building slowly, continues to accelerate and is truly bipartisan. An early evidence of the shift was President Truman's veto of the Reed-Bulwinkle Act in 1948 with the admonition that competition should continue to be applied to the trucking industry and that regulation, while it can guard against some abuses of monopoly power, "cannot be an effective substitute for the affirmative stimulus toward improved service and lower rates which competition provides." The bill was enacted over his veto.

Twenty years later a presidential task force wrote that "the bias of policy and its enforcement [in the regulated sector of the economy] is overwhelmingly against competition." In a 1970 report, the Council of Economic Advisors took an even stronger stand:

> "Regulation has too often resulted in protection of the status quo....change of any kind becomes hard to justify and even harder to allow....yet innovation and adaptation are the dynamics of economic progress."

The Congress and the courts have with increasing frequency in recent years come to rely on competitive forces, even in the regulated sector of the economy. In the Philadelphia National Bank case in 1963, the Supreme Court laid down the fundamental rule that even in a highly regulated industry, competition became "not less important but more so." Similarly in viewing state regulation, the Supreme Court has narrowed the antitrust immunity provided by the state action doctrine under Parker v. Brown, so that antitrust would apply more broadly to confirm the role of competition as the dominant economic theme in the absence of explicit state legislative decision to the contrary.

Even more dramatically, major legislative actions in recent years have tended to depend on competition and market mechanisms in industry after industry. The Bank Merger Act of 1966, the Atomic Energy Act Amendments of 1970, the Deep Water Port Act of 1974, the Federal Coal Leasing Amendments Act of 1975, all laid down the principle that antitrust policy in the service of competition could and should be consulted even in a highly regulatory environment. The Securities Act Amendments of 1975 terminated fixed commission brokerage rates with the result that institutional and individual rates have fallen sharply and the price of a seat on the New York Stock Exchange is now below that of a New York City taxicab medallion.

The next step was the end to regulatory control of entry and prices for air cargo carriers. That was swiftly followed by deregulation of fares and entry in the air passenger industry, and the mandatory sunsetting of the Civil Aeronautics Board under the Airline Deregulation Act of 1978. The gains in load factors and increases in revenue passenger miles, together with a proliferation of new entries and a variety of product-price combinations, are ample testimony to the success of air deregulation.

Another major step was taken in 1980 with the enactment of the Motor Carrier Reform Act. Once again the predominant theme was the relaxation of rate, entry and exit controls in favor of permitting marketplace forces to work. While the process was a phased one and is not yet complete, available studies and the opinions of shippers and customers strongly support the wisdom of trucking deregulation. The most recent steps in this trend were the Staggers Rail Act of 1980, making significant reforms in the economic regulation of railroads, and the Household Goods Transportation Act of 1980, designed to reduce regulation and increase competition in the household goods moving industry.

But in spite of amazing progress in the deregulation movement, the list of pervasively regulated industries in which competition is disabled by action of law is still long. The new administration seeks to continue the momentum by its support for deregulatory measures in a variety of industries, including petroleum and petroleum products and intercity bus transportation. Other targets of opportunity for the near future would include financial institutions, where historical industry lines are breaking down and the realities of the marketplace demand that regulators get out of the way; insurance, in which the McCarran-Ferguson Act denies the applicability of federal antitrust laws even where state regulation is ineffective or non-existent; agricultural marketing orders; and communications.

In the telecommunications industry, deregulation has been pressed by the Federal Communications Commission assisted by the courts of appeals. Kaleidoscopic changes in technology that are sweeping away traditional industry boundaries, plus the need for a maximum in efficiency and innovation have persuaded the regulators away from pervasive regulation. In the Hush-a-Phone (1956) and Carterfone (1968) proceedings, the FCC largely opened the field of telephone terminal equipment to competition. Likewise, the FCC gradually developed and approved direct long distance competition to the Long Lines Division of AT&T in the Above 890 (1959), MCI (1969), Specialized Common Carrier (1970), and Execunet (1977) rulings. Even more recently, in the First and Second Computer Inquiries, the FCC has attempted to carry forward the competitive theme by opening up communications/data processing segment of the industry to entry by, among others, AT&T.

Experience tells us that competition is to be preferred to regulation, except in natural monopoly situations. Regulation itself carries economic costs that must be weighed in the balance. Where monopoly exists, markets should continue to be regulated, although regulation must be strictly confined to deal with monopoly and its effects. It follows that, where a single business entity is to be involved in both regulated and unregulated markets, extraordinary measures must be in place to prevent the cross-subsidization of the competitive efforts from revenues in the monopoly markets. Such safeguards are difficult to construct, and their adequacy is difficult to monitor. Divestiture may well be the only satisfactory alternative.

As we examine S. 898, we are impelled to ask several questions. First, is true competition possible in the markets sought to be deregulated? Second, if not, what steps must be taken to insure that competition in a specific market does not result in its own extinction? Third, as to any specific deregulation proposal, are the means of guarding against monopolistic excess adequate to the task? And finally, if not, is structural alteration of the industry advisable to garner the benefits of competition and avoid the heavy weight of regulation?

With those questions in mind, we address telecommunications. Note first of all that a technological revolution is underway in the communications industry. Traditional boundaries between various modes of communications are being dissolved as the result of the introduction of new technologies that make obsolete much of the conventional wisdom in the industry. Coinciding with this decade of technological revolution have been policy changes, mostly from the Federal Communications Commission, which have created new and sweeping opportunities for competition with the prospect of significant benefits for consumers.

Yet both technological and regulatory developments have occurred against the background of one stark fact that is central to understanding the industry, and relevant to our conclusions today. In contrast to the motor carrier industry, which has supported some 15,000 separate trucking firms, in contrast even to the airline passenger industry in which the largest domestic air carrier has just over 20 percent of the relevant market, the telecommunications industry is dominated by one firm - AT&T. The Bell operating companies are admittedly joined in the local service market by some 1,500 independent telephone companies, and yet Bell serves over 80 percent of all telephones in this country and accounts for 83.6 percent of total operating revenues from telephone service. The next largest telephone company, General Telephone, serves only approximately 9 percent of our telephones, and the third largest, United Telecommunications, serves less than 3 percent.

The Bell System dominates local telephone service, long distance telephone service, and even in markets arguably subject to competition, such as terminal equipment manufacturing, the market share of Western Electric, the Bell manufacturing subsidiary, is approximately 80 percent. The fact of dominance alerts us to a major danger in deregulation in the industry, applying the principles we derived earlier. Deregulation is premised on the potential for competition. In any market in which one firm has market shares of 80 percent or perhaps more, deregulation which may result in the exchange of regulated monopoly for unregulated monopoly, must be viewed with concern for the viability of competition.

And yet, the status quo is neither desirable, nor can it be preserved. The telephone industry in this country is the world's best. AT&T, with all of its faults, has nevertheless produced a telephone system clearly superior to that in place in any other country in the world. The Bell System may not always have been innovative, nor efficient, nor inexpensive, nor polite, but it has, with its smaller industry partners, produced the result.

In an era in which efficiency must be a primary goal of economic organization, the dynamic forces of competition must be allowed to play in every communications market in which they can conceivably have beneficial effect. As a nation we cannot afford to tolerate a regulatory system that walls off one of the nation's most powerful corporations from vital markets. At the same time, we ourselves must be innovative and wary, lest the enormous power of this dominant firm destroy competition, suppress innovation and ultimately, punish the consumer.

It seems clearly appropriate, therefore, for Congress to proceed to write new rules of policy for the telecommunications industry. Outdated regulatory provisions must be rescinded, the Federal Communications Commission must be given new policy guidelines, and businessmen, both from incumbent dominant companies and from the new competitors, must know the rules of the game for planning purposes. The setting of national policy on telecommunications is clearly and preeminently a job for Congress.

A sharp distinction must be drawn, however, between establishing policy prospectively, based on one set of assumptions, and the role of an antitrust court in adjudicating whether or not a defendant has violated the antitrust laws, and then ordering remedies to prevent the recurrence of the violation and to restore competition to the marketplace. This is an absolutely crucial point in the telecommunications industry because of the existence of the government's antitrust case against AT&T.

In my view, although admittedly my knowledge is now somewhat dated, the government case against AT&T is pivotal to the resolution of this industry's problems. If the court makes a finding of liability on the part of AT&T, that fact by itself will be of paramount importance in organizing the industry for the future, because it will speak volumes about AT&T's opportunity, incentive and determination to behave in an anticompetitive fashion. If the Court determines, after a finding of liability, that the only appropriate remedy to prevent recurrence and to restore competition is divestiture, in order to remove incentives for anticompetitive conduct, that remedy should stand regardless of decisions in the interim either by the Federal Communications Commission or by Congress. On the other hand, if the government does not prevail in its case, at least there will be a thorough factual record to support any future planning in the industry. It is essential, therefore, that the case proceed to conclusion and that care be taken in the consideration of S.898 so that the legislation complement, and not supplant, the antitrust litigation.

Nothing could be clearer than the provision of

S.898 that expresses the intention of Congress on this subject. Section 404 establishes beyond doubt that the antitrust court is to proceed in its role of determining liability and ordering a remedy, unaffected by the fact that Congress has passed a law dealing indirectly with some of the same issues. Although some have argued that the legislation is inconsistent with the continued existence of antitrust cases, I am persuaded that a lucid judge who reads the words of Section 404 closely will decide the case without being influenced by the fact that S.898 has become law, as he should.

Some suggest further that the passage of S. 898, providing for the establishment of fully separated subsidiaries as a vehicle for introduction of the Bell System into unregulated markets, will inevitably, even if subliminally, affect the judge's determinations on remedy and make divestiture less likely. I disagree. The extraordinary remedy of divestiture, while it may be justified in this case, would only be ordered by a district court upon the strongest showing of necessity. The National Commission for the Review of Antitrust Laws and Procedures, on which some members of this Committee served, found that, while structural relief might be appropriate to restore workable competition in a market saddled by antitrust violation, it was rarely ordered for a variety of practical reasons, including the serious effects on private interests, increased tax liability and problems of implementation. Assuming a finding of liability, a trial court will likely order divestiture only after it has concluded that lesser remedies will be ineffective or possibly downright harmful.

In U.S. v. AT&T, if liability is found, divestiture may turn out to be the only effective remedy to remove the incentive and opportunity for anticompetitive behavior and to restore competition. If so, the fact that as the result of legislation requiring fully separated subsidiaries AT&T has been reorganized, should not affect a judge's determination that more is required. If the court is satisfied with subsidiaries after enactment, that means he would have ordered them even in the absence of legislation. Viewed in this light, S.898's requirement for fully separated subsidiaries is but a first step toward divestiture, if that is to be ordered by the court.

An alternative view might suggest that legislation await the outcome of the litigation. That would not be irrational. Nor would it take a very long time. The trial court judge in U.S. v. AT&T, assisted by able counsel on both sides, has wrought an unpublicized miracle in bringing that massive case to trial and trying it as efficiently as he has - an accomplishment for which I am confident in due course he will be recognized. Nevertheless, the cost of awaiting the result is likely to be high in terms of uncertainty and confusion. Moreover, properly interpreted, the legislation should prove no hindrance to the antitrust trial. I conclude that, on balance, it is best to proceed with the legislative effort.

The task remains to structure legislation to maximize competition across the range of telecommunications-related markets in which competition is workable, and at the same time to guard against the perceived potential for abuse by a dominant firm, AT&T, which would render the competitive potential a hollow reality. S. 898 focuses on one means of accomplishing these ends. First, it relaxes the prohibitions of the 1956 consent decree that concluded U.S. v. Western Electric Co., 1956 CCH Trade Cases ¶68,246(D.N.J. 1956). Then it establishes safeguards proporting to limit and regulate the potential for abusive cross-subsidization that could result in anticompetitive conduct in the newly opened markets. Each feature entails serious problems.

When AT&T entered into the 1956 decree it agreed to restrict its offerings to "common carrier communications services," which means "communications services and facilities, . . . the charges for which are subject to public regulation . . . ." There are several exemptions including one for "businesses or services incidental to the furnishing by AT&T . . . of common carrier communications services."

Section 223 of S. 898 adds a provision to the 1934 Communications Act providing that the 1956 consent decree "shall not act as a bar" to the provision by AT&T of "telecommunications service, telecommunications equipment, customer-premises equipment or information service" nor to AT&T's "engaging in any other business incidental to such activities . . . ." The effect of the provision, if enacted, will be to nullify the 1956 consent decree.

The same result - opening up to additional markets in which competition may be possible to AT&T - could be achieved in other ways. First, the decree court could reconstrue the provisions of the decree, as it has now been petitioned by AT&T to do, to achieve the desired result. Any such modification of the decree would seem to be at odds with the plain language of the decree and would clearly be contrary to the parties' original intentions. Thus judicial reinterpretation of the decree on an accelerated basis would not seem to be the most efficient way to proceed.

The Federal Communications Commission in the Second Computuer Inquiry sought to achieve a similar result by removing the charges for terminal equipment and enhanced services from regulation, thus leaving market forces free to determine those rates. When combined with the FCC's interpretation of the language of the 1956 decree, which permits AT&T to offer services under forms of regulatory oversight other than tariffs, the result is that AT&T can freely enter emerging markets for terminal equipment and enhanced communications services. While this is an appealing and simple way out of a complicated dilemma, it likewise depends on a decree interpretation somewhat at odds with the language of the decree. In any event, the Second Computer Inquiry has triggered appeals by most of the participants to the Court of Appeals for the District of Columbia, and thus final implementation must await undetermined delay.

Delaying the issue of modifying the 1956 decree until the termination of the government's case against AT&T might be the most orderly way to proceed. The decree court could adopt some of the factual findings of the trial court in the government's suit, and determine whether modification was appropriate in the light of the trial's outcome. But once again, delay has its costs and the legislative solution, if it is prompt, entails the benefits of the swift introduction of competition to new service markets. As long as the safeguards against the abuse of dominant market position are modestly effective, once again on balance the legislative solution seems slightly preferrable.

It has been suggested in some quarters that

Congress would be transgressing the constitutional scheme of separation of powers by enacting §218 of the bill, which separation of powers by enacting §218 of the bill, which purports to determine the effect of the 1956 decree. While the matter is not free from doubt, I am forced to conclude, on balance, that this section, as drafted, is probably constitutional. In State of Pennsylvania v. Wheeling and Belmont Bridge Company, 18 How. 421 (1856), the Supreme Court construed a statute passed by Congress that specifically stated that a particular bridge over the Ohio River was a lawful structure as presently constructed, and designated it a post-road. The Court had earlier issued an injunction requiring the modification or destruction of the bridge, having held that its construction violated a regulatory scheme passed by Congress that prohibited obstacles to navigation on the river. In view of the later legislation, the Supreme Court dissolved the injunction, holding that, while Congress was powerless to annul final judgments already rendered, it could prospectively determine that the bridge did not constitute an unlawful obstruction.

The action of Congress at issue in the Wheeling case is difficult to distinguish from the action proposed under §218, except that Wheeling involved an injunction rather than a consent decree. In another case, however, the Supreme Court has established the general principle that injunctions and consent decrees are both judicial acts, continually subject to modification in appropriate circumstances. United States v. Swift and Company, 286 U.S. 106 (1932) (Cardozo, J.). And in System Federation No. 91 v. Wright, 364 U.S. 642 (1961), the Court held that a consent decree should be modified to conform to changes in the general legislation governing the kind of activity affected by the decree.

While it is true that the Supreme Court has never precisely considered the case of legislation explicitly modifying a named consent decree, these decisions taken together strongly imply that the Court would uphold such legislation if presented with it.*

Moreover, all commentators seem to agree that Congress could achieve the result of overturning the 1956 decree by amending the underlying Sherman Act, or by specifically exempting AT&T or the same conduct from the Act's coverage. If that result is constitutional, I do not believe that the Supreme Court would rule otherwise merely because Congress chooses to achieve it through a different form of words, referring directly to the decree. Such a decision by the Court would exalt form over substance.

Once the means have been adopted to open up competitive markets to participation by AT&T, the task remains to develop a series of safeguards, if possible, to prevent anticompetitive conduct by AT&T resulting from its dominant market position in related communications markets. It is as to this one aspect of S. 898 that I must confess to substantial skepticism.

Whatever the merits of the rest of the scheme that the proposed legislation embodies, the concept of fully separate subsidiaries has its clear limitations. First, assuming the subsidiaries are completely separated and all connections are transparent, the sheer regulatory burden upon the FCC is overwhelming. This Committee has had testimony that the monitoring of cost and resource allocations and information flows is the kind of regulatory duty at which no commission, including the FCC, is adept. Add to that the possibility - some would term it a certainty - that AT&T will be less than fully forthcoming in supplying information in timely fashion and useable form, and you have a regulatory morass. The result would be a failure to protect against the possibility of abuse of market power, on the one hand, and the very opposite of deregulation, on the other.

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* Several decisions in the U.S. Circuit Courts of Appeals reinforce these conclusions. See McGrath v. Potash, 199 F. 2d 166 (D.C. Cir. 1952); Environmental Defense Fund, Inc. v. Costoe, 636 F. 2d 1229 (D.C. Cir. 1980). See also Western Union Tel. Co. v. International Brotherhood, 133 F. 2d 955 (7th Cir. 1943).

Second, all of that assumes that the bill gives the FCC maximum flexibility of regulatory authority to make swift adjustments in the structure of AT&T as business circumstances develop. It further assumes that the budget process will able to produce for the FCC adequate resources to do the job - an optimistic assumption in these times of severe budget constraints.

Third, even if regulation is successful in due course in detecting anticompetitive abuses, including cross-subsidies, the regulatory lag may be such that the potential for competition is suppressed before the abuse can be remedied. It will be of little comfort to a small business that has been driven from the market by AT&T that four, six or eight years later, the Federal Communication Commission's determination that AT&T acted improperly is upheld by the Court of Appeals. By then, it will be too late.

Finally, and most importantly, the concept of fully separated subsidiaries in no way alters the elemental incentives to act anticompetitively, although it may diminish the opportunities. Only divestiture, assuming such incentives exist, will suffice. A bill that allows common directors, rotation of management employees among the separate subsidiaries, shared facilities, consolidated income tax treatment, and a variety of other joint activities is likely to produce a reorganized AT&T that responds in the same way to external business circumstance as did the old AT&T. The parent controls the corporation just as fully as before. And the ability to engage in discrimination in favor of the subsidiaries, or to seek to circumvent regulatory controls can be reduced but never eliminated.

Is the choice then between total divestiture, on the one hand and the fully separate subsidary concept of S. 898, on the other? Perhaps not. A variety of intermediate measures have been proposed that merit the close attention of Congress. The General Accounting Office has proposed that limited equity participation by the parent firm in the subsidiaries would improve the situation. Others have suggested that the competitive service markets be open to AT&T more gradually, and the participation by the Bell System and these new markets be more closely watched. There are undoubtedly other measures that would improve the effectiveness of the separate subsidiary formula.

But at the end of the day, the question is whether the need to release the competitive energies of the Bell System in new communciations markets immediately is great enough to risk the possibility that the safeguards will fail and the potential for competition will be destroyed before it has had a chance to get started. Upon your determination of that balancing depends your conclusion as to the ultimate merits of this bill.

I personally would prefer to see a more measured application of the central concepts of this bill. It seems to me that certain markets are heartier, can be more conveniently monitored and are likely to result in greater benefits in the short run as the result of the introduction of vigorous competition. To assume, as the bill does, that all markets other than basic telecommunications service are or can be workably competitive is to assume too much. Perhaps terminal equipment and enhanced services are the markets in which to begin to test the concept of the bill, relying on the FCC in those limited areas to ensure that the experiment is not an early failure.

If it is to be all or nothing, then I confess a preference for the bill, but by a very thin margin. I cannot quite acquiesce in a state of affairs in which markets that could be opened up to competitive vigor are frozen in the status quo. If the safeguards fail, antitrust action by the Department of Justice will be required. And in the meantime, I would put my hope in the trial court's ability in the government's antitrust case against AT&T, in the light of its determination on liability, ultimately to determine whether the fully separated subsidiary concept or total divestiture, is the best hope for achieving competition in the communication markets of the next century.

In summary, I would favor applying the concept of S. 898 initially to only one or two markets. That would provide a limited test with fewer risks of remonopolization. On balance, I believe the 1956 decree should be legislatively modified as a necessary component of a deregulation bill. Finally, the government's case against

AT&T must continue to conclusion so that we have the benefit of the court's determinations concerning the structure of the Bell system. This dual approach will promote the most balanced planning for the future of the Nation's communications industry, because it will draw on the court's assessment of past conduct and Congress' prescriptions for future policy. With an industry this crucial, we can afford to do no less.

Senator SPECTER. The next panel consists of Mr. Victor Schnee and Mr. Robert E. Bennis.

Would you come forward please, gentlemen?

Mr. Robert E. Bennis is chairman of the regulatory committee of the International Communications Association, which is an association of telecommunications users consisting of 500 corporate, financial, governmental, and educational organizations, representing some 1500 professionals.

His member companies will spend approximately $10 billion for communications services and equipment in 1982.

Welcome, Mr. Bennis.

We appreciate your having submitted a statement. If you will summarize it in accordance with our practice, it will be made fully a part of the record.

STATEMENT OF ROBERT E. BENNIS, CHAIRMAN, REGULATORY COMMITTEE, INTERNATIONAL COMMUNICATIONS ASSOCIATION, NEW YORK, N.Y.

Mr. BENNIS. Thank you, Mr. Chairman.

Telecommunications, from a users viewpoint, essentially functions as the central nervous system of today's modern corporations.

Through innovative use of available telecommunications facilities, International Communications Association member companies have increased efficiency and improved productivity throughout our businesses.

At the same time, we pay a very significant price for this.

For example, in 1981, ICA member companies will pay over $10 billion for telecommunications services and facilities.

While we do business with practically every available supplier, the overwhelming proportion of these dollars are spent and paid to A.T. & T.

Indeed, conservative figures show that A.T. & T. commands over 80 percent of the market share for transmission services and well over 70 percent for terminal equipment

Senator SPECTER. Mr. Bennis, telecommunications users consist of what kinds of operations? Can you give us some examples of that?

Mr. BENNIS. Using my own company as an example, if I may, Westinghouse Electric is probably typical of a large business that depends heavily on telecommunications. We have our own private information network that handles about 95 percent of all of our telephone calls, a substantial percentage of all of our data traffic, practically all of our message traffic and facsimile traffic, and, more recently, office automation traffic and video conferencing kinds of calls.

These are the types of telecommunications facilities that I am referring to.

We do have a very critical stake in any effort to either alter the telecommunications environment or impact A.T. & T.'s ability or incentive to provide us essential telecommunications services.

As you know, S. 898 fundamentally affects both.

Let me say at the outset, that as businessmen, we support both the Congress and the administration in their attempts to deregulate industry.

As consumers, we should clearly benefit if this results in increased competition for telecommunication dollars.

We are concerned, however, that S. 898, as reported out of the Senate Commerce Committee, will actually stifle or possibly eliminate competition.

Based on experience, we know that effective competition simply does not exist in many markets today. We doubt seriously that there will be sufficient competition as a result of S. 898 to give users an adequate market choice in the foreseeable future.

Frankly, we anticipate an erosion and a possible demise of the modest amount of competition on which we have come to rely.

Senator **Specter**. Why do you think that the existing competition will be eroded?

Mr. **Bennis**. Having been in the business since the competition that exists today was introduced, going back 10 or 15 years, I know how difficult it has been as a user to find effective competitors in the marketplace.

Again, using my company as an example, we have gone out on a number of limbs over the years to support companies who were struggling to get a foothold in this business.

A notable example is MCI. We were one of their first users. Our financial people at that point in time told me that for all intents and purposes, MCI was bankrupt and we were taking a substantial risk even to do business with them.

Many of these users and ICA have nurtured these competitors and helped them to gain the footholds they have today.

It is our opinion that S. 898 has proceeded from the carrier's point of view. It has failed to take into account the existing structure of the telecommunications market. It has ignored the enormous market power and installed market base amassed by A.T. & T. in over 100 years of Government-protected monopoly operation.

Business, governmental, and educational users have long supported the need for a review of the Communications Act of 1934. We have supported communications regulatory reform in the interest of gaining greater economic stability and enhanced operating capability.

S. 898 does not meet these objectives.

Despite efforts to improve S. 898 before markup, omissions remain confirming that the bill and its sponsors continue to proceed from an inaccurate perception of the marketplace and the relative importance of different service offerings.

In order to implement increasingly sophisticated telecommunications capabilities, given the reluctance or the inability of the regulated carrier to fulfill our needs, large users created a competitive marketplace by investing billions of dollars in equipment connected to private dedicated lines that we lease from carriers—primarily A.T. & T.

These private dedicated leased line facilities are essential to the continued operation of our businesses.

We have recently been subject to dramatic increases in prices for these facilities, together with reduced availability in what appears to us to be a strategy to eventually eliminate them.

The net effect of this migration will be to increase costs while decreasing reliability, customer control, efficiency, and innovation.

So far this year, A.T. & T. has sought and obtained increases in the price of these private lines in the order of 40 percent.

Concurrently, the so-called competition—MCI and Southern Pacific, primarily—initiated increases amounting to 65 percent.

These inflationary costs ultimately must be borne by consumers vin the prices paid for the products they purchase.

Senator SPECTER. Sixty-five percent and 40 percent are a lot more than inflationary costs; are they not?

Mr. BENNIS. Yes, they are—very much so.

Senator SPECTER. How do you account for the significant difference between those increases and the rate of inflation, large as it is?

Mr. BENNIS. I do not know how the figures were arrived at, but there were two separate increases that were imposed by A.T. & T. and approved by the commission. One was 16.4 percent. It was followed within a several-week period by another one of 16 percent. That was followed with a restructuring of private line rates in the WATS area which added an additional percentage.

Coupled with that, as you may know, was the elimination of the Telpak offering, which was a bulk rate offering. That impacted the bottom line.

The 40 percent figure is a very real one.

In my company's case from a sheer dollar standpoint, it amounted to a $10 million a year increase without any added value whatsoever.

Senator SPECTER. Did your company lodge any protest on that?

Mr. BENNIS. Vehemently, yes.

We intervened in all of these cases before the commission. We submitted our testimony and found it was wanting. It was not sufficient to change their direction.

Senator SPECTER. You have suggested that the regulatory proceedings have an unreasonably restricted provision allowing only 30 days for protesting new tariffs.

Mr. BENNIS. That is right.

Senator SPECTER. What amendments would you suggest to provide more opportunities and perhaps more effective opportunities for public participation?

Mr. **Bennis**. At a minimum, I would expect that we would continue to enjoy the timeframe we now have which in most cases is up to 5 months.

Given the nature of these cases and the voluminous amount of information that A.T. & T. submits——

In the recent WATS case, for example, they submitted 17,000 pages of computer printouts.

It is literally impossible to evaluate these and analyze them and make any kind of a case in a 30-day timeframe.

Senator **Specter**. How would you compare the quality of equipment and innovation of Western Electric against that of its competitors?

Mr. **Bennis**. It is difficult to generalize.

Western Electric and the Bell System provide a very excellent grade of service and generally provide quality equipment.

In the last few years, however, with some degree of competition—particularly in the terminal equipment market—small innovative suppliers, such as Rolm Corp., Northern Telecom, Executone, and companies of that type, have far surpassed the Bell System in introducing new and sophisticated types of equipment.

Senator **Specter**. Do you think the future is strong for competition for Western Electric?

Mr. **Bennis**. Western Electric, I believe, given the opportunity and the provisions of S. 898, will in several years will completely dominate the equipment market. It will probably put out of business, or discourage new businesses from coming into the marketplace.

Senator **Specter**. What specifically in S. 898 will give Western Electric that enhanced position?

Mr. **Bennis**. I think, again, it is hard to generalize.

The basic intent, in my opinion, of S. 898 proceeds from the standpoint that competition exists and deregulation will merely enhance it.

As a user and representing a group of sophisticated users, we say they are dead wrong. That is not going to happen.

Senator **Specter**. How about with the equipment?

You say that notwithstanding the innovations of some of these other companies that that does not really constitute competition, as such—competition with Western Electric.

Mr. **Bennis**. Right now, Western Electric has reasonable competition in the terminal equipment market.

Senator **Specter**. At least there you think that competition exists.

If S. 898 is adopted, do you think there will be a hindrance to that competition?

Mr. **Bennis**. I believe so.

Senator **Specter**. Why?

Mr. **Bennis**. If I interpret it correctly, I believe the outcome of S. 898 will be to encourage the telephone company to engage in extremely predatory competitive practices to the extent that it will discourage new suppliers from coming into the marketplace and make it difficult for existing suppliers to continue.

Senator **Specter**. Thank you very much, Mr. Bennis.

We would like to turn now to Mr. Victor Schnee.

Am I pronouncing that correctly?

Mr. **Schnee**. That is completely acceptable. Different people in the family say it differently.

Senator **Specter**. Fine.

Mr. Schnee represents Probe Research, Inc., an independent research organization that has for the past several years published extensive studies of the telecommunications industry.

Welcome, Mr. Schnee.

STATEMENT OF VICTOR SCHNEE, PRESIDENT, PROBE RESEARCH, INC., MILLBURN, N.J.

Mr. **Schnee**. Thank you, Mr. Chairman.

Probe is a leading independent telecommunications research organization.

This month we released results of a 300-page, 9-month, multiclient study of S. 898, or computer inquiry-type restructuring of the Bell System.

We were asked to comment first on vertical integration and the impact on innovation.

Western Electric has been the overwhelmingly dominant monopoly supplier of telecommunications equipment to the Bell System—with, by our estimates, only about 5 percent or so of Bell's equipment needs purchased from outside.

We have carefully reviewed Bell literature supporting vertical integration and its record on innovation.

In view of the massive resources spent by Bell, we find nothing exceptional in the overall innovation results.

In the past 15 to 20 years, furthermore——

Senator **Specter**. You say "in view of the resources expended by Bell"?

Mr. **Schnee**. Yes.

Senator **Specter**. Nothing innovative?

Mr. **Schnee**. I did not say that.

Senator **Specter**. Or not sufficiently?

Mr. **Schnee**. I said nothing exceptional in the overall innovation results.

Senator **Specter**. How do you account for that?

Mr. **Schnee**. I do not know if I can account for it fully.

What I was going to go on to say was that in the last 15 to 20 years, we have found a trend where we feel they have been either taking sharply wrong turns technologically or falling behind in leading technologies.

Senator **Specter**. Others have moved ahead?

Mr. **Schnee**. Yes.

I enumerate in my statement.

I am talking about major areas; I am not talking about minor jiggles in the system. I am talking about areas like fiber optics, satellites, office telecommunications equipment—most notably PBX's—digital switches for local central offices, and packet switching. These are all major areas.

We have also found very serious shortcomings in Bell developments in other areas.

Senator Specter. Do you agree or disagree with Mr. Bennis' assertion that there is not really competition at the present time with Bell?

Mr. Schnee. I agree with him totally.

There is competition to a limited extent in the terminal equipment area, but it is to a limited extent.

The people in that area, because of vertical integration, cannot sell their equipment to the Bell System.

The Bell System is the largest distributor of equipment. It is a captive market for Western.

In my written statement, what I show is that Bell has been consistently behind on PBX development.

There is practically no purchase by the Bell System companies which in A.T. & T.'s words have independence in this area; yet they do not buy PBX's from the outside.

When the users have been given a chance to vote with their feet, they have been deserting the Bell products increasingly.

I also agree with Mr. Bennis very strongly that given the provisions of S. 898, the Bell System will be able to systematically have the ability to wipe out the competition that exists.

I think there are a few reasons for that.

One of them is that the FSA's that you are creating—or the FSS's under the *Computer Inquiry II*—are not even going to have their pricing subjected to the limited review that we get from regulation now.

It is impossible to detect all the routes of crosssubsidization in this system.

In our 300-page report, we demonstrated that. It is impossible.

Second, and a point that I will address right now that I wanted to get to later in my statement, is the colossal financial power that is being unleased here through the FSA's.

In our multiclient study, our financial models showed the FSA's could have assets initially of about $20 billion, long-term capitalization of about $16.5 billion, and revenues in year one of about $21 billion.

We also projected in our study that Bell could well pump into the FSA's an incremental $10 to $12 billion of financing in a fairly short period.

We gave a table in there showing the capitalizations of the leading companies in computers and office communications and office equipment in this country.

There is only one company in the entire country that is anywhere even in the league. That is IBM. The others—companies that you know as awesome companies like Control Data, Xerox, and such—are dwarfed by this.

The money derives from profits and credits of the monopoly businesses. There are no limits in this legislation on the flow of funds from the monopoly area to the FSA's.

Furthermore, beyond the advantage of being able to raise the money in the regulated area and then transfer it to the unregulated area, Bell enjoys the further advantage through legislation of being granted the most massive financial subsidies in U.S. history.

Last year, Bell received $2 billion in subsidies—money on which it pays no return to anyone—no dividends and no interest.

Since 1969, it has received about $18 billion in such subsidies.

Senator SPECTER. Would you elaborate on what you mean by those subsidies?

Mr. SCHNEE. The money comes to them through provisions that are buried in the Internal Revenue Code.

Essentially, what the Bell System is allowed to do—and other telephone companies are allowed to do this also, but Bell is the one that gets the lion's share of the dollars by the overwhelming percentage—in their rates, they are allowed to bill their customers for taxes which they do not have to pay. This arises through the use of accelerated depreciation and investment tax credit.

A normal company can use accelerated depreciation investment tax credit, but if it tries to price its product as if it were paying those taxes—in other words, if it tries to include the tax it saves—it is going to be wiped out by competition.

Bell is not only permitted but it is virtually mandated by a series of enactments passed by this Congress, starting in 1969, that Bell and the other telephone companies can collect that money from ratepayers.

In one instance, in the State of California——

Senator SPECTER. They can treat it as a cost, even though it is not a cost?

Mr. SCHNEE. They treat it as a cost, even though it is not a cost. Precisely.

It is return-free capital. It has been called phantom taxes.

We wrote a 42-page study on this issue, called the "Crucial Issue of Tax Benefit Financing."

Senator SPECTER. Has no one made an effort to amend the tax code?

Mr. SCHNEE. The efforts have been rather weak and dispersed to date.

The State of California has gone through about a 15-year battle with the Internal Revenue Service, the Bell System, and the GTE company, trying to get some effective change in this.

The State of Maine tried to avoid the effect of the law. What they did was rule it to be not in accordance with what the Congress had passed.

In our opinion, the failure of S. 898 to deal with A.T. & T.'s vertical integration and its numerous opportunities for crosssubsidization and distorted incentives to purchase Western Electric equipment, as well as the wholesale unleashing at the competitive marketplaces of billions of dollars raised under regulation or through Government-ordered subsidies, are extremely serious defects which among others undermine the stated purposes of the bill to promote competition.

I just want to mention two things on the above points.

No. 1, in the area of the Bell System innovation where we said that we found disturbing trends in the last 20 years where they had taken wrong steps or had been behind, we have some extensive examples in our written statement.

One of these involves the area of fiber optics where although they were not the technology leader, when it came time to awarding the contract for the major system that is going to determine the growth of fiber optics for the next several years, Bell awarded it to Western without even considering the more advanced competitive products.

Senator SPECTER. Does Bell ever do it differently? Do they ever award it to somebody other than Western Electric?

Mr. SCHNEE. In the crucial areas of the system, it is extremely rare, if ever.

Senator SPECTER. It happens sometimes?

Mr. SCHNEE. I do not know.

Senator SPECTER. Do you know where it has ever happened?

Mr. SCHNEE. I would be hard-pressed to find a critical area of the system.

Senator SPECTER. Any area.

Mr. SCHNEE. Any area—whether or not critical?

Senator SPECTER. Yes.

Mr. SCHNEE. They definitely do buy some equipment outside.

Senator SPECTER. Does Western make equipment that they choose not to buy in preference to buying outside?

Mr. SCHNEE. A typical situation is that Western's equipment is either not available at that time or it is in an area where Western's equipment is so far behind that they cannot really duplicate even generally what the trade has available.

In critical areas of the system, large-scale purchasing is virtually unknown.

There are always going to be exceptions to anything, but this is certainly the overwhelming rule.

Senator SPECTER. Do you think there should be some law which would compel them to buy from someone other than Western if the competition were a better product or a lower price?

Mr. SCHNEE. I think you need something like a quota system, frankly. The FCC has long since found——

Senator SPECTER. A quota system?

Mr. SCHNEE. Yes.

FCC has long-since found that the purchasing practice is unfair. They found this in 1977.

If it is unfair, it means they are not purchasing——

Senator SPECTER. After that finding, what did the FCC do, if anything?

Mr. SCHNEE. The FCC did nothing at all. In fact, they now have reinitiated another proceeding to go and restart to examine the same issues that were supposedly settled in 1977.

Senator SPECTER. In what areas does IBM compete with A.T. & T.?

Mr. SCHNEE. At this point, the competition is minimal really in the U.S. telecommunications market. There is virtually no direct competition.

IBM has a minority investment in one company which is a satellite carrier. That is SBS. IBM considered going into the PBX market in the United State It does not, after a series of events involving Bell in the early 1970's offer telecommunications equipment. It does offer some equipment for the billing of telephone calls, and A.T. & T. is a customer of theirs.

Senator SPECTER. Would you have any specific suggestions as to how S. 898 might be amended in order to encourage innovation?

Mr. SCHNEE. I frankly find S. 898 to depart so greatly from what is going to promote competition that I would have to be honest with you and say that it is necessary to start all over again.

Senator SPECTER. How about encouraging innovation? Is there any way to amend it to encourage innovation?

Mr. SCHNEE. I think you have to go back to the discussion on divestiture you were having previously.

I think as long as you have a vertically integrated structure, you are going to be fighting a very strong uphill battle to get the dominant——

Senator SPECTER. Do you favor divestiture?

Mr. SCHNEE. I would have to say I do favor divestiture.

Senator SPECTER. Thank you very much, Mr. Schnee and Mr. Bennis. We very much appreciate your coming.

[Material follows:]

Prepared Statement of Robert E. Bennis

Mr. Chairman, Members of the Committee:

Good afternoon, my name is Robert E. Bennis. I am Manager of Communications Systems for Westinghouse Electric Corporation. I am pleased to testify before you today on S. 898, the Telecommunications Competition and Deregulation Act of 1981, on behalf of the International Communications Association. ICA is composed of communication professionals, like myself, from some 500 of the largest corporations, educational institutions, state and local government agencies in the United States. These entities are headquartered, or have significant operations in every state and in many foreign countries. We rely heavily on telecommunications to help resolve complex financial, production, and operational problems.

Telecommunications essentially functions as the central nervous system of today's modern corporation. Through innovative use of available telecommunications facilities, ICA member companies have increased efficiency and improved productivity throughout our businesses. At the same time, we pay a high price for this. In 1981, ICA member companies will pay over $10 billion for telecommunications services and equipment. While we do business with every alternative supplier, the overwhelming proportion of this figure is paid to AT&T.

Indeed, conservative figures show AT&T to command over 80 percent of the market share for transmission services and over 70 percent for equipment.

LARGE CORPORATE USERS OF TELECOMMUNICATIONS HAVE A CRITICAL STAKE IN ANY EFFORT TO EITHER ALTER THE TELECOMMUNICATIONS ENVIRONMENT, OR IMPACT AT&T'S ABILITY OR INCENTIVE TO PROVIDE US ESSENTIAL TELECOMMUNICATIONS SERVICES. S. 898, AS YOU KNOW, FUNDAMENTALLY AFFECTS BOTH.

LET ME SAY AT THE OUTSET THAT AS BUSINESSMEN WE SUPPORT BOTH THE CONGRESS AND THE ADMINISTRATION IN THEIR ATTEMPTS TO DEREGULATE INDUSTRY. AS CONSUMERS, WE SHOULD CLEARLY BENEFIT IF THIS RESULTS IN INCREASED COMPETITION FOR OUR TELECOMMUNICATIONS DOLLARS. WE ARE CONCERNED, HOWEVER, THAT S. 898, AS REPORTED OUT OF THE SENATE COMMERCE COMMITTEE, WILL ACTUALLY STIFLE OR ELIMINATE COMPETITION. BASED ON EXPERIENCE, WE KNOW THAT EFFECTIVE COMPETITION SIMPLY DOES NOT EXIST IN MANY MARKETS TODAY, AND WE DOUBT SERIOUSLY THAT THERE WILL BE SUFFICIENT COMPETITION AS A RESULT OF S. 898 TO GIVE USERS AN ADEQUATE MARKET CHOICE IN THE FORSEEABLE FUTURE. FRANKLY, WE ANTICIPATE AN EROSION AND POSSIBLE DEMISE OF THE MODEST AMOUNT OF COMPETITION ON WHICH WE HAVE COME TO RELY.

IT IS OUR OPINION, AS USERS, THAT S. 898 HAS PROCEEDED FROM THE CARRIERS POINT OF VIEW. IT HAS FAILED TO TAKE INTO ACCOUNT THE EXISTING STRUCTURE OF THE TELECOMMUNICATIONS MARKET WHERE WE DO BUSINESS. IT HAS IGNORED THE ENORMOUS MARKET POWER AND INSTALLED MARKET BASE AMASSED BY AT&T IN OVER 100 YEARS OF GOVERNMENT-PROTECTED MONOPOLY OPERATION.

LARGE CORPORATE AND EDUCATIONAL USERS HAVE LONG SUPPORTED THE NEED FOR REVIEW OF THE COMMUNICATIONS ACT OF 1934. WE HAVE SUPPORTED COMMUNICATIONS REGULATORY REFORM IN THE INTEREST OF GAINING GREATER ECONOMIC STABILITY AND ENHANCED

OPERATING CAPABILITY. S. 898 DOES NOT MEET THESE OBJECTIVES.

SOME IMPROVEMENTS WERE MADE IN S. 898 BEFORE MARKUP. OMISSIONS REMAIN, HOWEVER, CONFIRMING THAT THE BILL AND ITS SPONSORS CONTINUE TO PROCEED FROM AN INACCURATE PERCEPTION OF THE MARKETPLACE, AND THE RELEVANT IMPORTANCE OF DIFFERENT SERVICE OFFERINGS.

IN ORDER TO IMPLEMENT INCREASINGLY SOPHISTICATED TELECOMMUNICATIONS CAPABILITIES, GIVEN THE RELUCTANCE OR INABILITY OF THE REGULATED CARRIER TO FULFILL OUR NEEDS, LARGE USERS CREATED A COMPETITIVE MARKETPLACE BY INVESTING BILLIONS OF DOLLARS IN EQUIPMENT CONNECTED TO PRIVATE DEDICATED LINES LEASED FROM CARRIERS, PRIMARILY AT&T. THESE PRIVATE DEDICATED LEASED LINE FACILITIES ARE ESSENTIAL TO THE CONTINUED EFFICIENT OPERATION OF OUR BUSINESSES.

WE HAVE RECENTLY BEEN SUBJECT TO DRAMATIC INCREASES IN PRICE FOR THESE FACILITIES, TOGETHER WITH REDUCED AVAILABILITY IN WHAT APPEARS TO BE A STRATEGY TO EVENTUALLY ELIMINATE THEM. THE NET EFFECT OF THIS MIGRATION WILL BE INCREASED COST AND DECREASED RELIABILITY, CUSTOMER CONTROL, AND EFFICIENCY.

ALREADY THIS YEAR, AT&T SOUGHT AND OBTAINED INCREASES IN THE PRICE OF PRIVATE LINES IN THE ORDER OF 40 PERCENT. CONCURRENTLY, THE "SO-CALLED" COMPETITION, SPC AND MCI, INITIATED INCREASES OF UP TO 65%. THESE INFLATIONARY COSTS ULTIMATELY MUST BE BORNE BY CONSUMERS IN THE PRICES PAID FOR THE PRODUCTS THEY PURCHASE. THE PATTERN OF RATE INCREASES SURELY DEMONSTRATES THE WEAKNESS OF TODAY'S COMPETITION.

TELECOMMUNICATIONS IS NOT A PAROCHIAL ISSUE. IT IMPACTS NATIONAL AND INTERNATIONAL ECONOMIC POLICY. S. 898 FAILS TO EMBRACE THIS FUNDAMENTAL REALITY.

SEVERAL ISSUES REMAIN PROBLEMATIC FOR US. FIRST, WE BELIEVE THAT LEGISLATION THAT SETS NATIONAL TELECOMMUNICATIONS POLICY FOR THE FIRST TIME IN 40 YEARS MUST BE DEVELOPED WITH GREATER CARE AND DELIBERATION. S. 898 ADDRESSES A HIGHLY COMPLEX INDUSTRY WITH BROAD SOCIAL, ECONOMIC, AND POLITICAL IMPLICATIONS RESULTING FROM THE DEPENDENCE ON TELECOMMUNICATIONS OF VIRTUALLY EVERY INDUSTRY. SUCH FUNDAMENTAL POLICY MAKING SHOULD BE APPROACHED WITH CONSIDERATION GIVEN TO AND GUIDANCE SOUGHT FROM ALL, NOT JUST THE DOMINANT COMMON CARRIER AND ITS FEW COMPETITORS. S. 898 WAS RUSHED THROUGH WITHOUT ALLOWING CONSUMERS AND BUSINESSES SUFFICIENT TIME TO PRESENT THEIR VIEWS.

SECONDLY, S. 898 SETS POLICY ON A FUNDAMENTAL MISUNDERSTANDING OF THE TELECOMMUNICATIONS INDUSTRY. S. 898 ASSUMES THAT COMPETITION EXISTS AND DEREGULATION WILL ASSURE ITS GROWTH. THE BILL REQUIRES CONTINUED REGULATION OF PRIVATE-LINE SERVICES BY THE DOMINANT CARRIER UNTIL A FINDING IS MADE BY THE FCC THAT EFFECTIVE COMPETITION (I.E., REASONABLY AVAILABLE ALTERNATIVES IN "SIMILAR" SERVICES) EXISTS. NO FIRM GUIDELINES OR FORMULA ARE SPECIFIED, HOWEVER, TO AID THE COMMISSION IN THIS CRITICAL DETERMINATION. THIS COULD LEAD TO THE ELIMINATION OF ESSENTIAL USER SERVICES THROUGH DEREGULATION PRIOR TO THE DEVELOPMENT OF TRULY EFFECTIVE COMPETITION.

THIRD, WHERE SERVICES DO REMAIN REGULATED, S. 898 SEVERELY RESTRICTS PUBLIC PARTICIPATION IN REGULATORY PROCEEDINGS. FOR EXAMPLE, CUSTOMERS WOULD HAVE ONLY 30 DAYS TO PROTEST THE VALIDITY OF FILED TARIFFS. PUBLIC PARTICIPATION IN THE REGULATORY PROCESS IS ESSENTIAL INASMUCH AS AT&T, IN RECENT YEARS, HAS FAILED TO FILE A SINGLE MAJOR TARIFF DEEMED TO BE LAWFUL BY THE FCC. THOSE FINDINGS WERE MADE ONLY IN RESPONSE TO USER GENERATED PETITIONS FOR REVIEW. THIRTY DAYS IS SIMPLY INSUFFICIENT TIME FOR REVIEW OF VOLUMINOUS SUPPORT DATA THAT THE CARRIER REGULARLY FILES WITH ITS TARIFFS BEFORE THE FCC. IN OUR VIEW, THE CUSTOMER SHOULD BE AFFORDED A MORE EFFECTIVE ROLE, RATHER THAN THE REVERSE.

FOURTH, MANY LARGE USERS HAVE INITIATED AT TREMENDOUS COST PRIVATE TELECOMMUNICATIONS SYSTEMS IN AN EFFORT TO STABILIZE COSTS THAT HAVE FLUCTUATED WIDELY. S. 898 THREATENS THESE INVESTMENTS BY PROPOSING STEEP ACCESS FEES TO INTERCONNECT THESE PRIVATE FACILITIES TO THE CARRIER'S LOCAL NETWORKS. SUCH FEES WOULD BE REGULATED BY THE INDIVIDUAL STATES, WHERE AT&T'S INFLUENCE IS GREATEST. THIS DISSERVES BUSINESS AND CONSUMER ALIKE.

FIFTH, IN THE INTEREST OF COMPETITION, WE ARE CONCERNED ABOUT THE ADEQUACY OF THE STRUCTURAL SEPARATION BETWEEN AT&T AND ITS COMPETITIVE, FULLY SEPARATED SUBSIDIARY DEFINED BY S. 898.

"BABY BELL" WILL BE AN ENORMOUS, VERTICALLY INTEGRATED, MULTI-NATIONAL CORPORATION WITH WHICH FEW WILL BE ABLE TO COMPETE. THE "FULLY SEPARATED AFFILIATE" WOULD DIFFER FROM OTHER COMPETITORS IN THAT IT WILL BE RELIEVED OF ANY START-

UP COSTS AND MAY SHARE MANY CONTINUING COSTS WITH ITS PARENT. WE ALSO QUESTION THE ADVISABILITY OF PERMITTING AT&T OFFICERS TO CONTROL THE OPERATION OF THE "FULLY SEPARATED AFFILIATE."

I HOPE I HAVE BEEN ABLE TO CONVEY, MR. CHAIRMAN, THAT TELECOMMUNICATIONS IS SIMPLY NO LONGER THE EXCLUSIVE PROVINCE OF THE COMMON CARRIER. LEGISLATION AIMED AT CHARTING A COURSE FOR CARRIERS OR ADDRESSING ONLY THE RELATIONSHIP BETWEEN CARRIER AND REGULATOR IS SIMPLY NOT SUFFICIENT IN PERSPECTIVE. THE NEEDS OF USERS AND COMPETITIVE SUPPLIERS MUST BE CONSIDERED. HOWEVER IT ALL BEGAN 100 YEARS AGO, TELECOMMUNICATIONS IN THE LAST 20 YEARS HAS BECOME BUSINESS ITSELF. AS BUSINESSMEN, WE KNOW HOW TO LIVE WITH UNCERTAINTY. BUT LEGISLATION WHICH GETS INTO OUR BUSINESS WITHOUT A FULL APPRECIATION OF ITS DYNAMICS IS BAD LEGISLATION AND BAD FOR BUSINESS.

AT ICA WE APPRECIATE YOUR WILLINGNESS TO TAKE A SECOND LOOK AT S. 898. WE WILL CONTINUE TO BE INVOLVED IN THE LEGISLATIVE PROCESS, AND WILL, OF COURSE, FURNISH YOU WITH ANY INFORMATION THAT YOU MIGHT REQUIRE NOW OR IN THE FUTURE. THANK YOU FOR GIVING ME THE OPPORTUNITY TO TESTIFY. I'M HAPPY TO ANSWER ANY QUESTIONS THAT YOU MIGHT HAVE.

STATEMENT OF PROBE RESEARCH, INC.

Prepared by: Victor Schnee, President, Inc., and
Walter J. Gorkiewicz, Executive Vice
President, Director of Research

We are appearing here at this Committee's invitation. Probe Research is an independent research organization. We have no ties, financial or other, to any other party which is in the telecommunications industry or involved in this legislation.

Probe has for the past several years been the leading publisher of in-depth studies of the telecommunications industry. In 1976 we published a book entitled "The Future of AT&T," the most comprehensive and carefully documented study of AT&T ever published. The American Banker stated that "The Future of AT&T became a widely used basic primer on the communications giant and ... contained many projections that have come true."

We have continued our in-depth studies of the industry for the past five years, with emphasis on new technologies and products, financial aspects, and major policy questions. Just this month, July, 1981, we released nearly 300 pages representing the results of a nine-month multi-client study entitled, "The Strategy Implications of the Unleashing of Bell's Unregulated Business Subsidiary." This is a unique, in-depth analysis of the issues raised by S.898 or Computer Inquiry-type restructuring of the Bell System.

We have been asked to comment first on the Bell System's vertical integration and the impact on innovation. Vertical integration refers to the fact that AT&T owns Western Electric. Western Electric has been the overwhelmingly dominant, monopoly supplier of telecommunications equipment to the Bell System.

What is the impact on innovation of having the Bell System procure virtually all of its essential telecommunications equipment from its own captive supplier? We wish to point out at the outset that our evaluations are not based on academic theory. We are looking at actual events and experiences of many years. We believe that Probe's work on Bell innovation is unique. Virtually the only source of information on Bell's record previously has been AT&T itself. This is unfortunate. However, later I'll describe what AT&T does to an organization like ours which develops independent analyses of the Bell System.

The question of vertical integration and the impact on innovation is a two-sided coin. On the one hand, there is the impact on Bell's innovation, and on the other the impact on non-Bell manufacturers.

Let's look at Bell's record first. We have carefully reviewed Bell literature supporting vertical integration and its record on innovation. In view of the massive resources spent by Bell, we find nothing exceptional in the overall innovation results from Bell and Western. Furthermore, we find in the major developments of the past 15-20 years a disturbing trend. AT&T has often either taken dramatically wrong directions technologically or fallen behind in major telecommunications technologies and product areas.

Let me mention some of these areas: 1) Fiber Optics, 2) Satellites, 3) Office Telecommunications Equipment, most notably PBXs, 4) Digital Switches for Local Central Offices, 5) Packet Switching. These are all major areas for the future of telecommunications. Over the last twenty years there have been serious shortcomings in Bell's developments in several other areas: Picturephone, Electronic local office switches, Semiconductors, for example.

Let's use fiber optics as an example. At the outset, note that of the five major breakthrough developments in this technology - 1) establishing the theoretical basis for low.loss fiber fabrication (by ITT in 1966), 2) the actual production of low loss fiber (by Corning in 1970), 3) the development of graded-index fibers with their high bandwidth potential (by NEC) 4) the invention of semiconductor lasers (by GE, IBM and MIT independently) and 5) the development of long wavelength graded-index fiber (by Corning) - none of these were Bell developments. Bell in fact in the late 1960's championed a different approach - gas-filled tubular metal pipes to carry light beams, an approach since relegated to obscurity.

The potential of fiber optics, which may dramatically transform communications of all types in the next several years, could not be lost on AT&T, which began to announce small system developments in the late 1970's. In 1980, AT&T announced plans for a Northeast Corridor fiber optic system from Boston to Washington. For this major project, despite the excellent pace of innovation in the outside industry, Bell chose to rely strictly on Western Electric as a sole source supplier for fiber and cable.

In so doing, Bell clearly failed to propose a state of the art system. Despite the fact - well known in the trade - that there was available from other U.S. suppliers fiber which would have effectively doubled the capacity of the system, Bell failed to even contact these outside fiber, or cable, suppliers for its system.

This single project dwarfs all U.S. procurement for fiber and cable to date. By this single stroke Bell establishes Western - which has not been the technological leader, and lacks a proven production capability - as the overwhelmingly dominant U.S. supplier of optical fibers.

Now we said there was another side to this coin, namely the impact on the outside producers. A clear message has been sent that the Bell market is essentially closed to any largescale outside procurement. Innovative companies who have pioneered the technology face the prospect of being locked out of the major marketplace. This is the result of Bell's favoring its vertically integrated, captive supplier. We believe that the implication is clear - and Corning, for one, has expressly warned the FCC about this - that this type of situation destroys the incentives of outside suppliers to innovate for telecommunications markets which are under the control of AT&T.

In the PBX area, Bell's pace of innovation has lagged dramatically. While it told the FCC in 1976 that:

> "The Bell System had an unmatched record of PBX innovation before Carterfone and has had an unmatched record since."

- The fact is that a high level Bell Labs memo in 1969 had noted:

> "During the last several years, it has become increasingly apparent that we have sadly neglected PBX development."

Probe also noted an AT&T operating company memo in 1975 stating that 59% of its large PBX investment represented equipment incorporating pre-1930 technology.

Furthermore, while Bell told the FCC in 1976 that it had developed "virtually every feature and technique of the modern PBX," the fact is that the vast preponderance of truly modern features have been introduced first by outside suppliers. A short list of these features follows:

Feature	Addressed By Bell since Offered (as of 7/81)
Digital Switch	No
Electronic Feature Phones	Yes
Non-Blocking Switching	No
Data Terminal Switching Sharing Voice Wiring	No
Call Data Recording and Analysis	Yes
Directory Systems	No
ACD	Via Tariff of Gen'l Trade
TAS	Via Tariff of Gen'l Trade
Protocol Conversion-Data Terminal	No
Elimination of Switchhook Flash for Feature Initiation	No

Despite these facts, the Bell System buys virtually all of its PBX equipment solely from Western Electric. This contrasts sharply with the actions of users, who when given the opportunity to vote with their feet, have increasingly been deserting Western's product line and choosing competitive equipment. It is probably true that the PBX market offers the first real test of the validity of Bell's claims for vertical integration. If so, it is clear that vertical integration is failing in the marketplace. Nonetheless, as well as the outside suppliers have been doing, it would be naive not to recognize that their failure to sell PBXs to Bell itself is limiting their growth and is an indication of the distorted incentives created in a vertically integrated system. It is the users, the ratepayers of the Bell System, and the country in general, which pays the price for any suppression of innovation and acceptance of inferior products.

Let me allude briefly to some of the other areas mentioned above. Bell has been years behind the competition, and its own announced plans, in introducing digital switches for its local central offices. Even though there are several switches available from outside suppliers, and Bell's own ESS No. 5 switch is still under development, Bell's construction budget projects that Bell will buy nearly 6 million lines of ESS No. 5 from Western through 1985. By contrast, qualified outside vendors will probably sell virtually no switches to Bell for its larger local offices (above 10,000 line size), which are the heart of its system.

In packet switching, Bell with great fanfare announced a system in 1978, called ACS, for Advanced Communications System. In 1979, its application to the FCC was withdrawn due to technical difficulties. It should be noted that packet switching had been introduced to the marketplace years earlier by small competitors, originally by Telenet Corp., in 1975, and Tymnet, a subsidiary of Tymshare. These innovators, however, have good reason to fear that under the anticompetitive provisions of S.898, or Computer Inquiry II, their viability may soon be threatened by the late-arriving Bell, which has a vast ability to cross-subsidize developments such as ACS.

Other developments, such as satellites, Picturephone, electronic switching, semiconductors, are largely technologies of the 1960's. Probe has found that Bell's claims were often not matched by its actual achievements in these areas. In satellites, for example, Bell has issued much self-adulation for Telstar. But this satellite was actually heading in the wrong direction technologically.

Picturephone was a fiasco which eloquently illustrates the reasons why claims on behalf of vertical integration must be viewed very cautiously. Bell, using the "resources" of vertical integration, spent allegedly over $500 million developing a system which, literally, nobody wanted, despite all of Bell's glowing foecasts of the success of the product.

Electronic switching, ESS No. 1, also illustrates the peril of accepting Bell's claims at face value. While AT&T featured ESS No. 1 on the cover of its annual report in 1964, contemporaneous, internal documents reveal, that the system could not even be operated for the basic tests at that time. While ESS No. 1 went into service in 1965, it took nearly ten more years before it achieved the capacity it was designed for ten years earlier. By then many experts considered it technologically backward. This did not deter Bell, which by 1975 had purchased nearly $4 billion of these switches from its vertically integrated supplier, Western Electric, and has continued to purchase billions of dollars more in the past several years.

In semiconductor technology, Bell made claims in the 1960's that "Bell Laboratories and Western Electric working hand in hand" had developed a "new resource" in integrated circuits and that "the new integrated circuit technology ... will make this intimate association among designers and producers more important than ever." Yet an internal Bell Labs presentation in 1972 complained about "our progress in integrated circuits," including "the long time needed to design and get models made of a new device, the distressingly low yield in manufacture and resulting high cost of many devices that had reached the stage of Western manufacture...." A 1973 internal study admitted that Bell had been "behind outside competition in the production of integrated circuit devices."

Numerous other areas could be cited. For example, Bell has claimed that "linking research, manufacture and operations," i.e. vertical integration, "assures" the prompt development of new scientific advances. However, its own internal documents indicate that in some areas "which ... require the detailed hands on knowledge of the Operating Companies' day-to-day problems, the development of work of the Bell Laboratories has been less than outstanding." Among the areas cited as strongly needing improvement were local loop and station equipment - These two areas constitue about 45% of Bell's total plant.

In evaluating vertical integration, one must also note Bell's claims that vertical integration also helped cause a "remarkable" price advantage in which Western's equipment averaged 65 to 85% of the lowest outside prices for comparable equipment. Such claims were based on bell's own internal price comparison studies. However, in 1977, the FCC completely rejected these studies as being invalid for numerous reasons.

We might mention that Bell continues to use the studies in state rate cases to this very day.

Regarding S.898, we have concluded that, regardless of the stated purposes of the bill, it is highly anticompetitive legislation. I would like to address one aspect - but it is a very important aspect - the failure of the bill to deal with the colossal financial power which Bell can unleash through its Fully Separated Subsidiaries, FSAs.

Our recent multi-client study contained a financial model showing that the FSAs could have assets initially of about $20 billion, long-term capitalization of $16.5 billion and revenues of nearly $21 billion.

We also project that, based on certain financial assumptions spelled out in our study, AT&T could well pump into the FSAs an incremental $10 to $12 billion of financing in a fairly short period.

Furthermore, that money will derive from the profits and credit of the monopoly businesses of Bell, which are virtually guaranteed a profit. S.898 in no way limits the flow of funds from the monopoly area to the FSAs.

This is a critical fact. It is also very significant in evaluating vertical integration. Bell's record of innovation is based not just on vertical integration, but also on a system where failure had no real penalty attached. If Bell spent $500 million on ESS No. 1 and it didn't work properly - or $500 million on Picturephone which couldn't be sold - there was always more money behind it.

Furthermore, even with its vast regulated financing advantages, Bell enjoys further advantages through legislation passed by this Congress which grants it the most massive financial subsidies in U.S. history. Last year alone, Bell received $2.7 billion in subsidies - money on which it pays no return whatsoever. Since 1969 it has received about $18 billion of such subsidies. The benefits issued to Bell by U.S. legislation make other subsidy-seekers, such as New York City, Lockheed and Chrysler, look like pikers. We issued a 42 page study of this subsidy matter in 1977. Our study remains unquestioned.

We conclude that S.898 does not deal with pre-existing problems in the telecommunications industry, involving AT&T. Failure to deal with AT&T's vertical integration and its distorted incentives to purchase Western Electric equipment, and the wholesale unleashing into competitive marketplaces of billions of dollars raised under regulation or through Government-ordered subsidies - are extremely serious defects, which among others, undermine the stated purposes of the bill.

This bill truly embodies a philosophy that "What's good for the Bell System is good for the U.S." The record, however, does not justify that philosophy.

I would like to make one final point. Probe has received a number of unsolicited invitations from Senate and House panels to appear regarding telecommunications legislation and AT&T restructuring. In 1979 we appeared before the Senate Commerce Committee, Communications Subcommittee.

Shortly thereafter we became aware that Probe was being subjected to an unusually intensive campaign of surveillance of and interference with our research efforts by AT&T and the Bell System.

Eventually, when the New York Public Service Commission conducted a preliminary investigation of a mysterious disappearance of several weeks of Probe's telephone billing, the PSC obtained documents showing that Bell System-wide surveillance of and other interference to Probe's activities were ordered by very high officials of AT&T, and with the full knowledge of virtually all the top officials of AT&T.

Among the high AT&T officials, or former officials, who have been kept well-informed of Probe's activities, and AT&T's countermeasures:

W.S. Cashel, Jr., Vice Chairman of AT&T and Chief Financial Officer

F.M. Garlinghouse, AT&T Chief Counsel

R.E. Allen, AT&T Vice President

J.A. Baird, AT&T Vice President

J.R. Billingsley, AT&T Vice President

E.M. Block, AT&T Vice President

J.S. Cave, AT&T Vice President

R.N. Flint, AT&T Vice President

J.G. Fox, AT&T Vice President

D.E. Guinn, AT&T Vice President

W.B. Kelly, AT&T Vice President

A.J. McGill, AT&T Vice President

J.L. Segall, AT&T Vice President

W.G. Sharwell, AT&T Vice President

D.C. Staley, AT&T VIce President

A. von Auw, AT&T Vice President

These documents show: 1) AT&T actions were directly tied to Probe's legislative appearance and its subsequent research study which derived from interest expressed by the Communications Subcommittee and Staff, 2) AT&T high officials were deeply concerned that further Probe research would reach legislators and regulators, and 3) the orders were sent to virtually every top level executive of the entire Bell System, and then transmitted down to even very low level employees.

We also wish to point out that hostile AT&T actions towards Probe followed the publication of Probe's "The Future of AT&T." An investigation which was described as similar to a "credit check," was surreptitiously conducted by New Jersey Bell's Security Department, on orders from the AT&T Security Department. It involved attempted intimidation of Probe employees, checking on employee's personal lives with the police, attempts to compromise the

Probe principals by asking Probe employees how the authors obtained their information, and other acts.

At AT&T insistence, Probe's contacts with the entire Bell System, since Probe's legislative appearance, have been discriminatorily interfered with - in AT&T's words - "coordinated" through highly-paid AT&T attorneys, even with respect to simple press release requests by Probe. Probe's experience has been that this action has been a thinly-disguised attempt to impede the flow of information to Probe, even to the extent of withholding already-available press releases and other material.

Although the New York PSC ordered an investigation, AT&T has refused to turn over key documents and information, citing - among other things - that the PSC has no jurisdiction over it.

,/To legislate properly the Congress needs unbiased information from qualified sources.

We hereby Petition this Committee to investigate and reveal on the public record the full story of AT&T's activities in trying to suppress independent research by Probe, and interfere with the legislative and regulatory process.

Attachments.

EXHIBIT 1

AUGUST 20, 1979.

Messrs. R. E. Allen, J. A. Baird, J. R. Billingsley, E. M. Block, J. S. Cave, R. N. Flint, and J. G. Fox.

Also Messrs. F. M. Garlinghouse, D. E. Guinn, W. B. Kelley, A. J. McGill, J. L. Segall, W. G. Sharwell, D. C. Staley, and A. von Auw.

RE: PROBE

In my letter of October 12, 1978, I discussed the various publications of PROBE. In addition, Mr. Kuehner has been sending you the quarterly index of the PROBE Telecommunications Journal. In that correspondence, we pointed out that PROBE was publishing material with a strong anti-Bell bias and making it available to the financial community.

In May 1979, Victor Schnee, an attorney (Harvard Law), former member of the Hart Antitrust subcommittee staff and one of the principals of PROBE, testified before a Senate Communications subcommittee advocating greater clarity in the legislative proposals regarding Bell subsidiaries. He also testified against accelerated tax depreciation and the investment tax credit as "a $2.2 billion a year subsidy to the Bell System." Subsequently, PROBE has proposed (attachment "A") to construct a financial model of the A.T. & T. competitive entity.

It has recently come to our attention that PROBE has been making direct inquiries to various units of A.T. & T. In one specific case, PROBE personnel spent a full day visiting one A.T. & T. organization and other less lengthy telephone contacts have been reported. These instances suggest that with the turnover of personnel, etc., PROBE is still able to get direct access to knowledgeable management people who are unfamiliar with the full background of this matter.

The need to have newspaper and magazine reporters clear through a central point, namely the PR Department, is widely recognized. It is equally desirable to have financial research people use a central point the Investor Relations Section. Therefore, should anyone in your organization be contacted by Messrs. Schnee, Gorkiewicz, Lapin or anyone else of PROBE, please direct them to either Lou Winkelman (393-6141) or Charlie Kuehner (393-3391).

Attachment "B" is the latest PROBE Quarterly Index. Anyone in your organization may borrow the complete publication by calling Lou Winkelman on 393-6141.

W. G. BURNS.

Attachments.

ATTACHMENT A

[From Communications News, August 1979]

PROBE INITIATES STUDY ON PROPOSED AT&T ENTITY

Probe Research has initiated a multi-client consulting project which will result in a preliminary financial model of the proposed AT&T competitive entity. The results are expected to be submitted to the Senate Communications Subcommittee for legislative purposes.

In an invited appearance before the Senate subcommittee hearings on the Communications Act Amendments of 1979, Probe stated that the AT&T competitive entity (or entities) might end up as a multi-billion dollar operation and "could be an extremely significant business organization, perhaps dwarfing all others in the industry besides AT&T itself." Probe told the subcommittee that "it is unfortunate that there has been no attempt to draw up a preliminary financial model of what it would look like in dollars and cents terms."

Probe was subsequently approached and asked to construct such a model. Probe decided that participation in the study would be open to all industry members.

For information, contact *Probe Research, Post Office Box 251, Millburn, New Jersey 07041.*

EXHIBIT 2

NEW YORK, N.Y., *October 29, 1979.*

From: Office of Vice President and General Counsel.
To: All officers.

For your information. If we have had any contacts from the PROBE organization, I would appreciate being advised.

G. E. ASHLEY.

OCTOBER 12, 1979.

Messrs. R. E. Allen, J. A. Baird, J. R. Billingsley, E. M. Block, J. S. Cave, R. N. Flint, and J. G. Fox.
Also Messrs. D. E. Guinn, W. B. Kelley, A. J. McGill, J. L. Segall, W. G. Sharwell, and A. von Auw.

RE: PROBE RESEARCH

The expanding activities of Probe Research ("PROBE") have been previously reported to you in Bill Burns' letters of October 12, 1978 and August 20, 1979. Until recently, PROBE has concentrated on financial analysis of the Bell System. On this basis, the Investor Relations Section was the central point of contact to coordinate responses to PROBE's inquiries.

PROBE is now making inquiries into the research, operations and competitive policies and actions of the Bell System. More recently, the information received by PROBE is being used, we believe, to support the preparation of testimony for the legislative, antitrust and regulatory forums. Press reports indicate that PROBE also provides "consultations" for Bell System competitors. In view of this basic change in the nature of PROBE's activities, it has been determined that the Legal Department should become the point of contact for PROBE-related matters.

Therefore, in the future, any information requests from PROBE or its principals, Victor Schnee, Walter J. Gorkiewicz and Douglas M. Lapin, as well as their associates are to be channeled solely through the Legal Department. Gerry Murray (212-393-6555) and Bob Sutherland (212-393-4833) are the attorneys assigned to coordinate responses to PROBE contacts. Copies of the PROBE Telecommunications Journal will continue to be available for loan from Lou Winkelman (212-393-6141) in Investor Relations.

Copies of this letter are being sent to the Long Lines Department, Bell Telephone Laboratories, Bell Operating Companies and to AT&T Assistant Vice Presidents so that all system personnel can be made aware of this change. We also recommend that this matter be brought to the attention of employees who join your respective organizations in the future.

W. S. CASHEL, Jr.

Concurrence:

F. M. GARLINGHOUSE.

EXHIBIT 3

[From the Washington Post, Wednesday, November 9, 1977]

A $750 BOOK—A.T. & T. DROPPED PROBE OF HIGHLY CRITICAL STUDY

(By William H. Jones)

American Telephone & Telegraph Co. undertook an investigation earlier this year into the origins of a book highly critical of the giant utility.

Spokesmen for A.T. & T. last night confirmed that a short-lived probe was begun and then dropped after the company purchased the book and determined that it lacked "proprietary information" promised in an advertisement.

In another development, informed sources said the Federal Communications Commission is looking into an attempt by A.T. & T.'s Washington subsidiary to bar former agency lawyers from participating in legal cases involving the nation's largest corporation.

The book at issue is "The Future of A.T. & T.," published last year by Victor Schnee and Walter J. Gorkiewicz, who are selling it for $750 a copy.

According to A.T. & T. spokesmen, when an advertisement for the book was published in The Wall Street Journal, a security officer at Bell System headquarters in New York noticed a claim that the publication would contain proprietary or private company information about A.T. & T.

The company's security officer, identified as Ray Ryan, subsequently asked representatives of New Jersey Bell Telephone Co., in Newark, to look into the matter. Ryan since has taken a new job with A.T. & T.

Pete Hoffman, general news manager of New Jersey Bell (an A.T. & T. subsidiary), said last night that his firm received a note from Ryan on Feb. 8, asking: "What did we know about it" New Jersey Bell was contacted because the firm publishing the book, Probe Research Inc., had a Millburn, N.J., address.

On March 1, Hoffman continued, New Jersey Bell security department investigator James Arnold started to pursue the case and made a telephone call to the home of Probe Research circulation manager Rita Tannenbaum.

Hoffman said Arnold reached Tannenbaum's husband and began asking questions about the book and asked if he could visit the Tannenbaum residence, which also had a Probe Research business telephone.

Tannenbaum declined to be interviewed personally. Later, according to Hoffman, Rita Tannenbaum called the New Jersey Bell investigator and discussed the book.

Arnold told New Jersey Bell that the Tannenbaums claimed there was no proprietary information in the book and that many of the details previously has been published in the Washinton Post, The Washington Star and Business Week.

After that, Hoffman said last night, Arnold did no more work on the case because A.T. & T. notified its subsidiaries that it had purchased a copy of the book and could respond to any inquiries.

The Tannenbaums could not be contacted yesterday but the book's co-author, Schnee, said in a telephone interview from his home in Summit, N.J., that the March 1 call to his associate was the first of a "distrubing sequence of events."

He said another Probe worker has received "mysterious" telephone calls and the tires on his own car were deeply cut late last month. Summit police chief Thomas Finneran said Schnee reported the incident and that the police investigated but were at a loss to explain the slashings—which he described as more extensive than the normal punctures by vandals.

The A.T. & T. and New Jersey Bell spokesmen said that so far as they knew, there were no further probes of Schnee or his associates after March 1, although no formal notice about discontinuing the investigation was sent, Hoffman said.

"I'm very worried about it," Schnee said.

In an unrelated case in Washington, involving A.T. & T. subsidiary Chesapeake & Potomac Telephone Co., the D.C. Bar Association's ethics committee currently is studing a request that former FCC lawyers be barred from taking part in cases involving the Bell System.

C & P vice president and general counsel Robert A. Levetown filed ethics charges against Ruth S. Baker and Herschel F. Clesner, in the past 14 months stating that they were in violation of bar association rules which forbid former government lawyers from participating in cases they worked on while in government employ.

Both Baker and Clesner worked on an FCC study of A.T. & T. Currently, Baker is with the law firm of Cohn & Marks, which specializes in communications cases and represents independent telephone equipment manufacturers. Clesner works for a House subcommittee, but represented citizens groups for free in a C & P rate cases in Maryland.

Baker declined to comment on C & P's action, as did her lawyer and officials of C & P. Clesner did not respond to a telephone call yesterday.

Informed sources said, however, that the C & P petition now is being studied by the D.C. Bar Association and that a decision may be forthcoming in about a week.

FCC staff members reportedly are looking into the C & P case as well, to determine A.T. & T.'s role—if any.

In a formal reply to the D.C. Public Service Commission, after a C & P complaint about her involvement in a case there, Baker said the local telephone firm seems to claim that "mere employment" as an FCC lawyer on a Bell System case "must automatically disqualify her from future employment in any matter, before any forum," that might include Bell System information "whether or not these documents have the slightest relevancy to the matters at issue."

Senator SPECTER. We will move on to the third panel: Professor Harry First, Professor Robert Willig, and Mr. Carl Thorsen.

Professor First is currently professor of law at the New York University School of Law where he has taught for the past 5 years.

Previously, he was an attorney in the Antitrust Division of the Department of Justice.

He is a graduate of the University of Pennsylvania, cum laude, in 1969, and is a Penn undergraduate. He is Phi Beta Kappa.

Welcome, Professor First.

STATEMENT OF HARRY FIRST, PROFESSOR OF LAW, NEW YORK UNIVERSITY SCHOOL OF LAW, NEW YORK, N.Y.

Mr. First. Thank you for adding those things, Senator.

I want to first thank the committee for inviting me to speak here today.

I was asked to talk about two particular points. One is the competitive implications of vertical integration. The second is the burden which S. 898 puts on the FCC in terms of future regulation.

ANTICOMPETITIVE EFFECTS OF VERTICAL INTEGRATION

Senator Specter. Professor First, do you think that vertical integration can ever constitute an antitrust violation?

Mr. First. Can ever?

Senator Specter. Yes.

Mr. First. Yes. The question is when.

Senator Specter. Thank you for asking that question.

[Laughter.]

Now would you please answer the question?

Mr. First. Vertical integration has caused many problems for theoreticians in terms of figuring out exactly what is wrong with it.

Senator Specter. And Congress.

Mr. First. And economists, lawyers, and so forth.

The area which I think is most suspect, and in which I have concentrated my remarks, is the area where you have a firm which is vertically integrated with a monopoly position in less than all of its markets.

It seems to me that if one looks at past cases—and you can go back to 1911 in the old *Standard Oil* monopolization case—you find that those sorts of firms tend to engage in what I would call anticompetitive practices. There are many of cases like this. These practices are anticompetitive in the sense that they are done to exclude competitors at the competitive stage—the stage at which they do not have a monopoly—and anticompetitive in the sense that they are often intended to shore up the monopoly power which they do possess, because monopoly power can end at some point.

I tried to indicate in my remarks that I thought there were four particular types of problems or types of practices that one could expect.

The four are as follows:

Refusals to deal, when the monopolist refuses to sell its product to those at another stage.

Price squeezes, where the monopolist sells its product at a high price to the competitive stage and then resells it at a very low margin of profit to force competitors out.

Product design manipulations, where the monopolist is able to alter product designs, interface requirements, and so forth, in a way which excludes competitors at the competitive stage.

Market foreclosure, which was discussed earlier—purchasing from or selling to its own captive suppliers or outlets.

I should say, and presumably Professor Willig will say it as well, that economists think some of these practices, are not all that bad, or necessarily inefficient, such as market foreclosure.

In the product manipulation cases which I have noted in my prepared remarks, the courts did not think the defendants' conduct was so bad because in those particular cases, involving IBM and Eastman Kodak, new products were offered—of course, it was in a way that severely disadvantaged their competitors.

These are very difficult issues. In any event, I think those are the four types of practices which one could expect from a vertically integrated monopolist.

THE REGULATED MONOPOLIST

I would also like to add two others when the firm with monopoly power is a regulated monopoly, obviously because that pertains to A.T. & T.

One is the obvious effort to avoid earnings limitations at the regulated level by manipulating transfer prices, the price at which it purchases things from its unregulated subsidiary, and also by manipulating output prices.

How does an integrated regulated/unregulated firm allocate costs—joint and common costs—for a product that is sold in the unregulated environment?

These are very difficult issues which even the most scrupulous firm, and I will assume A.T. & T. will be that, will have problems deciding. How do you price computer time at 3 in the morning?

It is going to be very hard to decide. Inevitably, there are incentives to aid the unregulated side by keeping its costs low.

THE DIVESTITIVE ALTERNATIVE

Senator SPECTER. Who would make that decision as a matter of practice or as an ideal matter? If you assume that A.T. & T. will have separated affiliated companies where the affiliated company would be subject to direction from somebody in the other company, if they are totally separate corporations, then corporation B cannot be told by corporation A.

Mr. FIRST. I would have them totally separate corporations—in other words, divestiture, for which others have argued.

Senator SPECTER. You would go the divestiture route?

Mr. FIRST. It seems to me that there is no way in which you can alter these incentives truly. Even if you have totally altered them, you suspect that you have not, so you will have to watch them.

That, it seems to me, is an inevitable problem of not taking these assets out of A.T. & T. and letting people manage these assets in a truly competitive, which would avoid these problems.

Senator SPECTER. What is the strongest argument, in your judgment, against divestiture?

Mr. FIRST. The strongest argument, I think, from Bell's point of view ought to be that they should be allowed to enter these markets on a fully integrated basis.

I think that they ought to argue, although they are not so far as I can tell, that they have tremendous efficiencies in terms of design, marketing, and operations. It is one system, after all. You cannot break us apart, and we will bring those efficiencies to these new markets.

Senator **Specter**. In your opinion, is there validity in such a contention should Bell adopt your contention?

Mr. **First**. It seems to me that no one can say that there are no efficiencies in a vertically integrated A.T. & T. operation. I think people who have studied it cannot say that.

Senator **Specter**. If you do not go the route of total separation and divestiture, in your judgment is there any way to structure affiliated companies to have reasonable safeguards?

Mr. **First**. No. I think, in essence, that the concept is flawed.

The problem it seems to me is that the more separate you make the affiliate the less reason there is to have the company affiliated.

In other words, the benefits of vertical integration are to have them affiliated. Bell is saying they will have it fully separate. Then you have to ask: Why go through all of this? Why have them in the same corporate fold. Let us just divest the assets. Let us let them be on their own.

Senator **Specter**. Is there any suggestion you would have short of divestiture?

Mr. **First**. No.

Senator **Specter**. Thank you.

Professor Willig is a professor of economics and public affairs at Princeton University. He was formerly supervisor of the economic research department at Bell Laboratories.

He received his Ph. D. in economics from Stanford in 1973, a masters in operations research in 1968 from Stanford, and did his undergraduate work at Harvard.

Welcome, Dr. Willig.

STATEMENT OF ROBERT D. WILLIG, PROFESSOR OF ECONOMICS AND PUBLIC AFFAIRS, PRINCETON UNIVERSITY, PRINCETON, N.J.

Mr. **Willig**. Thank you, Mr. Chairman, for the privilege of testifying here today.

I would like to say that I have worked for the Bell System in the past—in fact, in the very recent past. I have also worked for other parties in the industry. Today I am here entirely independently and trying to steer an entirely objective point of view.

In my opinion, S. 898 is a good bill in many regards. However, I feel there are several areas in which changes in the bill would serve the public interest.

These areas are the relationship between a fully separated affiliate and the rest of A.T. & T.; cable deregulation, about which we have heard nothing today and I wonder if it is off the agenda; the definition of effective competition; exchange access; and regulated oligopoly.

I would like to discuss my concerns in each of these areas if time permits.

FULLY SEPARATED AFFILIATE

First, the FSA—the fully separated affiliate.

There is a fundamental conflict in the formulation of policy toward the telecommunications industry.

While many services should clearly remain regulated because of conditions of natural monopoly and entry barriers, many other products could be sold competitively with the consequent overriding benefits of progressivity and market discipline.

A.T. & T. could productively supply all of these goods; yet any firm that supplies both regulated and unregulated goods must have powerful incentives to divert revenues toward its unregulated operations and costs toward its regulated ones.

Senator SPECTER. Do you think that the fully separated affiliate concept would be successful in providing competition?

Mr. WILLIG. It will be successful to some extent in providing competition. However, I do not think it will be able to avert anticompetitive acts and practices, should the dominant carrier respond to its profit incentive to behave in this manner.

As I detailed in my written statement submitted for the record, S. 898 provides both substantial incentives and opportunities for A.T. & T. to behave anticompetitively—to the detriment of rivals and consumers.

DIVESTITURE VERSUS EFFICIENCIES OF INTEGRATION

Senator SPECTER. Do you agree or disagree with what Professor First has had to say about his preference for the option of divestiture?

Mr. WILLIG. I am not so quick to reach a conclusion on this issue, sir, because I do not have the facts in my pocket on how important the efficiencies of integrated operation are.

I have read widely in the area, and I have studied some public documents on the question. However, I have not seen A.T. & T. step forward and make a strong affirmative case for what those efficiencies might be.

On the other hand, I am not sure anyone has asked them directly to make that case in a detailed way.

Senator SPECTER. What additional information would you like from Professor First?

Mr. WILLIG. I would like to see you, sir, if I may be so presumptuous, inquire of a representative of the corporation here in this seat: We are sure there are anticompetition problems with the bill, but we also understand there may be countervailing efficiencies. Tell us what they are and convince us of their importance.

I would like to see that happen.

Senator SPECTER. A.T. & T. did testify here at an earlier proceeding.

Mr. WILLIG. And did they speak to the efficiencies of integrated operation in the areas in which the FSA would operate?

Senator SPECTER. I was not present that day, so I could not answer the question for you. There is a full hearing record which will shortly be available.

Mr. WILLIG. I look forward to seeing that.

There is a point that Professor First made that I would like to underscore as well.

The bill seems to try to prescribe that A.T. & T. and the affiliate interact as if they were unaffiliated, except with regard to foreign sales and national security. These are important exceptions written into the version of the bill that I studied.

I feel that this prescription will be unenforceable as the bill is written. However, the question remains as to why the bill does not order the entities to actually be unaffiliated, rather than just act that way.

Again, the answer must be the efficiencies of integration. Yet these are not mentioned or reflected in the bill as I read it.

Senator SPECTER. I am advised by counsel that although that subject was addressed in a general way by A.T. & T., they did not provide the kinds of specifics which counsel feels would be required for an economist to give an opinion.

Mr. WILLIG. I see.

Senator SPECTER. Your suggestion is a good one, and that is a line that can be the subject of further inquiry.

Mr. WILLIG. Yes. Thank you.

FOREIGN SALES AND NATIONAL SECURITY ACTIVITIES

I am concerned about the exceptions of foreign sales and national security activities. I understand there has been some concern in the Congress about these activities, and perhaps rightfully so.

One suggestion which I have not had a chance to study but which I would like to throw out for your consideration is that the FSA could be divested after a suitable transition period. At that time, a permanent joint venture could be created between what used to be the FSA and the rest of A.T. & T. with the specific and limited purpose of pursuing foreign sales and national security activities.

If the most important efficiencies of integration do inhere in foreign sales and national security activities, that could be a way to preserve those efficiences and, at the same time, create a cleaner boundary between the competitive activities and the regulated ones.

CABLE DEREGULATION

I would like to make some remarks on cable deregulation if there is time.

As I read it, the bill proscribes regulation of prices charged by cable system operators. Regulation of prices will no longer be permitted by the commission, by States, and also by their political subdivisions. There are two limited exceptions.

In my view, these exceptions are far too narrow. They should be broadened to permit State or local regulation of any cable services for which there are no reasonably available alternatives and no effective competition.

As such, prices for basic cable connection, pay TV programing, and two-way interactive cable services could be regulated if conditions so warranted.

Senator SPECTER. Do you believe that cable systems should compete with telephone operating companies in providing telecommunications services?

Mr. WILLIG. No; I do not. Actually, I like the way the bill is structured in permitting the telephone companies to lease their facilities to others who would stipulate the content and provide final mass media services in competition with cable systems.

I am comfortable with the provision of the bill keeping the telephone companies themselves out of matters of content and out of providing final mass media services. I think that these provisions will best promote competition and diversity in mass media services in the long run.

Cable television is presently a local natural monopoly, protected by sunk-cost entry barriers. While different geographical areas are often served by different cable system operators, almost nowhere do consumers now have a choice between two or more competing cable system operators. There is a natural pattern of monopolization in the industry. It may change over time with technological advances.

At the present time, I think it is clear that there is substantial local monopoly power in the industry; and that it can be exercised to the detriment of the public in several ways.

One way concerns prices charged consumers for basic pay, and the new interactive cable services. Other ways take effect further upstream. Cable systems can, and sometimes do, anticompetitively discriminate in their service offerings, in the prices charged for different services, and in the prices they pay providers of services and programs.

Such discrimination would favor programing sold by corporate relatives of the cable system. It is made possible by the local monopoly power of the cable system. This discrimination diminishes competition among programers, and vitiates consumer sovereignty over program options and information flow.

I think these problems are not academic, but are rather real in the eyes of many industry observers. There is ample evidence for this viewpoint. These problems are controlled today, to some extent, by the municipal regulation of cable that would be weakened by the bill.

In my view, the public interest would be better served if States and their political subdivisions remain somewhat unregulated in how they choose to oversee cable systems that are essentially local public utilities.

However, deregulation of cable services is appropriate where there are determined to be reasonably available alternatives or effective competition.

Senator SPECTER. Thank you very much, Mr. Willig.

I would like to turn now to Mr. Carl O. Thorsen, chief communications rates analyst for the New York State Department of Public Service.

We welcome you, Mr. Thorsen.

Your statement will be made a part of the record, and we would appreciate it if you would summarize. Perhaps you might begin by telling us just a little bit about the scope of activities of the New York State Department of Public Service.

STATEMENT OF CARL O. THORSEN, CHIEF COMMUNICATIONS RATES ANALYST, NEW YORK STATE DEPARTMENT OF PUBLIC SERVICE, ALBANY, N.Y.

Mr. THORSEN. Thank you very much, Mr. Chairman.

I am pleased to have the opportunity to address this committee today.

I do, in fact, represent a State that has actively advocated and encouraged competition and deregulation in the communications industry.

Accordingly, we have been sensitive to the need for sound procedures necessary to guard against the potential for cross-subsidies. The text of my statement does detail our experience.

Senator SPECTER. Tell us a little bit about the scope of the activities of your department, if you would, please?

Mr. THORSEN. One of the major activities that we have undertaken is the separation of competitive and noncompetitive lines of business for both the dominant and nondominant carriers, as discussed by the bill.

This action is much the same as that required of section 220 of the proposed legislation.

We have, indeed, found subsidies. However, we also believe that the measures we have taken are effective in eliminating and identifying the cross-subsidy of competitive products by other services.

Senator SPECTER. What sorts of activities does your department concern itself with beyond the matters which we are discussing today?

Mr. THORSEN. Beyond those matters from a pragmatic standpoint, we have promoted competition. We have encouraged our legislature to pass legislation which would grant our commission the ability to selectively deregulate certain markets.

Senator SPECTER. Markets involving what commodities or products?

Mr. THORSEN. Markets involving terminal equipment; markets involving radio and telephone utility operations; markets involving the telegram business.

This July our legislature did, in fact, pass a bill deregulating the telegram business within New York State.

Senator SPECTER. You are in favor of S. 898.

Mr. THORSEN. Yes, we are, Senator.

Senator SPECTER. I see from the testimony which you have submitted.

What is your response to the testimony which has been presented about unleashing tremendously powerful forces which will consume all in sight?

Mr. THORSEN. The antitrust penalties are rather stiff. It is very evident at this point to A.T. & T. that in fact it can hurt. We have the *Litton* antitrust suit, the *MCI* antitrust suit, and the incentive as Professor Willig has pointed out.

Senator SPECTER. Do you think those suits have been effective?

Mr. THORSEN. I could not say whether they have been effective or not. It certainly highlights the necessity to operate aboveboard and indicates that the concerns raised are valid. At the same time, A.T. & T. must recognize that it can——

Senator SPECTER. You refer to the antitrust laws and then to the suits. There is a real issue as to the effectiveness of antitrust enforcement against the Bell System and against A.T. & T.

MCI representatives appeared in these hearings about 1 week ago where I had the opportunity to chair. They described a treble damage action which had gone to verdict in Chicago, resulting in a verdict of $1.5 billion. The MCI official had grave questions as to whether that had any significant impact on A.T. & T.

We heard testimony earlier today from the former Justice Department official, Mr. Shenefield, on the litigation battle between the Government and A.T. & T. He talked about A.T. & T. and the avalanche of paper, almost as if the Government did not have an adequate paper supply with which to reply.

The question comes up in my mind, and you have addressed it, and I would be interested in your opinion as to the effectiveness of this litigation.

Mr. THORSEN. Bearing in mind that the litigation is not yet complete, that will go on through further appeals.

Our experience in New York with the Bell System is that they are extremely sensitive to antitrust litigation to even the appearance on the part of their employees for the products they offer and the prices they offer those products for.

In fact, they will not do things that we as a staff encourage them to do, including the direct sale of items of equipment in competition with other suppliers.

I will summarize and say, yes, it has been effective.

Senator SPECTER. There is that concern.

Do you think that the methods of observation or surveillance or detection are adequate, given the provisions of S. 898 to uncover anticompetitive or monopolistic practices?

Mr. THORSEN. Yes.

Senator SPECTER. How would you response to Professor First's question about who is going to decide what the charge is at three in the morning for something?

Mr. THORSEN. If that is a regulated service, the regulators will decide. If it is an unregulated service, the marketplace will determine what the charges are.

Senator SPECTER. If you have affiliated companies, can you be sure that if A controls B and it is A's interest to make a lower charge to drive out the competition that the competition really will decide if B can shift its costs to A?

That is the thread which has come through so much in these hearings. I frankly do not know the answer, nor do I have even an instinct for it.

Mr. THORSEN. I think you have to recognize that in large part the testimony has alluded to the size of A.T. & T. and of Western Electric.

Regardless of whether the potential for cross-subsidy exists between a monopoly and the competitive market, Western alone, it could be said, whether under a divested company or a fully separate affiliate, may have the power to engage in an anticompetitive practice.

I do not think that divestiture will adequately change the ballfield in which you deal, compared to a fully separated affiliate.

Senator SPECTER. You think that Western would be strong enough to be anticompetitive if it chose to do so?

Mr. THORSEN. I believe any large corporation could be if it chose to do so.

Senator SPECTER. How about that, Professor First?

Mr. FIRST. I do not know what the shape of Western Electric ought to be in divestiture. I do not know enough about it.

Senator SPECTER. How about if Western Electric is big enough and strong enough and tough enough to be anticompetitive even if it is divested?

Mr. FIRST. There are two ways of looking at it. Firms can always engage in cross-subsidization if they choose to do so.

The question is: Why would they choose to do so.

Senator SPECTER. Aside from the cross-subsidization, Western may just want to take a loss and drive somebody out of business.

Mr. FIRST. Again, the question is what are they going to get from it. Is it worth taking a loss now? What does the long run look like? Will they be able to keep firms out?

If you have a regulated monopolist, they do not take the loss; because they have unexercised monopoly power and they can recover those. That is the real problem, I think, with having it attached.

Senator SPECTER. Mr. Thorsen, your statement goes to the issue of stressing the ability of the FCC to rely upon cost allocations and prevent cross-subsidy. You say that New York has been able to accomplish that, or your department has?

Mr. THORSEN. We are very confident in our ability to do so as a State.

Senator SPECTER. How large is your staff and how do you do it?

Mr. THORSEN. We have approximately 100 staff members in the communications division, approximately 40 of which are dedicated to the review of costs.

We have, for example, in the analysis of our competitive terminal equipment market, which my testimony details, imputed a higher rate of return or cost of equity in recognition that this is a competitive market.

We have used current costs in recognition that anyone entering the market must face today's costs.

Senator SPECTER. Do you feel that you have enough people to really do an adequate job of looking at what is going on?

Mr. THORSEN. For the size of the industry we regulate in New York, yes, sir.

Senator SPECTER. Do you think that S. 898 will really be deregulation or reregulation of telecommunications?

Mr. THORSEN. I do agree with prior statements that in the short term it will be heightened regulation. There will be a mountain of engineers and economists and accountants.

Senator SPECTER. And in the long run?

Mr. THORSEN. Not necessarily overreacting but a necessary initial reaction.

Senator SPECTER. How about the long run?

Mr. THORSEN. In the long run, we believe that it will result in less regulation and more competition and benefits to consumers.

Senator SPECTER. At what point do you think the short run ends and the long run begins? [Laughter.]

Mr. THORSEN. I would not touch that with a long or short pole. [Laughter.]

Senator SPECTER. Mr. Willig, you are on the same panel. What would you say to that question?

Mr. WILLIG. On the question of the long and the short run reregulation?

Senator SPECTER. We have cross-subsidies within the panel here. [Laughter.]

Mr. WILLIG. I am very frightened by the reregulation inherent in the bill. Every study that the FCC has undertaken, and other regulatory agencies also in the past, on cross-subsidy have been interminable and inconclusive.

This bill opens up an enormous scope for new kinds of determination of cross-subsidy all over the lot. They will be necessary.

Senator SPECTER. Gentlemen, we thank you very much.

As I said with the first panel, but did not say although equally applicable to the second panel, I wish that we could spend longer taking advantage of your expertise in these fields.

However, we must move on to panel four.

We thank you all very much.

[The prepared statements of Messrs. First, Willig, and Thorsen follow:]

PREPARED STATEMENT OF PROF. HARRY FIRST

I. Introduction

Mr. Chairman and members of the Committee. I am Harry First. I am currently Professor of Law at New York University School of Law, where I have taught for the past five years. Prior to that I taught at the Unviversity of Toledo, for four years, and was an Attorney in the Antitrust Division of the Department of Justice. My major areas of interest are antitrust and government regulation.

I have been asked to testify with regard to the provisions in S. 898 allowing AT&T to provide certain nontelecommunications services, primarily the manufacture and sale of customer-premises equipment and the provision of information services, on an "unregulated" basis through the device of a "fully separated affiliate" (FSA). Specifically, I have been asked to address the competitive implications of vertical integration in this situation, and the implications of these provisions for FCC regulation.

My remarks are divided into three parts: 1) What are the general competitive problems raised by vertical integration? 2) Should AT&T be allowed to operate in unregulated markets on a fully inegrated basis? 3) If not, is the FSA or divestiture the proper solution here? It is my opinion that vertical integration poses overwhelming competitive risks here, and that that the FSA structure is not the proper solution. Competition would more effectively be promoted -- and costly regulation avoided -- through the divestiture of these operations from AT&T.

II. What are the Competitive Problems Raised by Vertical Integration?

1. Economic Theory.

Vertical integration raises difficult theoretical problems for economists dealing with antitrust and competition issues. Many argue that vertical integration is both common (every firm has "vertically integrated" some of its activities) and innocuous at worst. Official studies, such as President Nixon's Task Force on the antitrust laws, express skepticism about arguments that vertical integration somehow adds to a firm's monopoly power.1/ Robert Bork writes that "aside from the efficiency effect . . . vertical integration does not affect the firm's pricing and output policies." 2/ Others point out that vertical integration is often undertaken for positive reasons -- either to achieve operating efficiencies or to minimize "transaction costs" (i.e. the costs of inter-firm dealings). 3/

On the other hand, a significant group of economists have been able to construct theoretical cases against vertical inegration in certain situations: 1) The input monopolist integrating forward into a competitive industry can, under certain conditions, extend its monopoly power by lowering total firm operating costs and raising final output prices. 2) Vertical integration can increase monopoly profits by allowing the integrated firm to price discriminate in its favor. 3) Vertical integration may raise entry barriers or facilitate oligopolistic coordination (although the theoretical case for these two propositions is weaker). 4/ 4) Of particular relevance to AT&T and the telecommunications industry, it is well accepted that backward vertical integration is a way to circumvent price controls on a regulated monopolist 5/ 5) Some (but not all) economists believe that vertical integration lessens competition when competing suppliers are foreclosed from sales to a monopolist. 6/

2. Anticompetitive Conduct by Integrated Single-Stage Monopolists.

I would like to concentrate my remarks on one type of vertical integration -- vertical integration by a firm with monopoly power at less than all levels of the production and distribution process. I think it possible to predict that this type of vertically integrated firm will engage in certain practices whose purposes and effects are anticompetitive, in the sense that they are designed to exclude rivals in competitive markets and strengthen or maintain the integrated firm's

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[1] See Antitrust & Trade Reg. Rep. No. 413, June 10, 1969, p. X-6.

[2] R. Bork, The Antitrust Paradox 228 (1978).

[3] See, e.g., R. Posner, Antitrust Law: An Economic Perspective 200 (1976)(cost savings): O. Williamson, Markets and Hierarchies: Analysis and Antitrust Implications 84-85 (1975).

[4] See Kaserman, Theories of Vertical Integration: Implications for Antitrust Policy, 23 Antitrust Bull. 483, 497-509 (1978).

[5] See id. at 502-03;2 A.Kahn, The Economics of Regulation 262 (1971).

[6] Kahn, supra note 5, at 263-64.

position in its monopoly market. This predicted behavior has been shown in numerous antitrust cases, going back to the original Standard Oil monopolization case in 1911 which details Standard's operations as an inegrated refiner-transporter-marketer of petroleum products and its efforts to exclude competitors. 7/ Indeed, just as noncompetitive pricing can be predicted from a concentrated horizontal market structure, so too can anticompetitive practices be predicted from a vertical market structure which mixes monopoly and competitive stages.

The first anticompetitive practice is refusing to deal. A good example is the Terminal Railroad case, decided the year after Standard Oil, in which group of competing railroads used their joint control over St. Louis access and terminal facilities to exclude competing railroads. 8/ A more recent example of this sort of behavior is the Otter Tail Power Co. case, where a vertically integrated electric power company sought to and did use its natural monopoly position in electric power transmission to thwart retail competition by refusing to transmit power to a potentially competing municipal retail company. 9/

In addition to leveraging power from one stage to another by refusing to deal with competitors at the competitive level, integrated monopolists have frequently resorted to squeeze pricing to accomplish their objectives. In these cases the monopolist sells its product to itself and others at the next stage of production at a high price, and then resells at that stage with only a small margin of profit, making it difficult for competitors to operate. Alcoa, with a monopoly in aluminum ingot, affected competition in the business of rolling aluminum ingots into sheet by squeezing the margin between ingot and sheet; 10/ Eastman Kodak tried to force retailers out of business by selling them film for the same price it was selling film to retail customers at its own outlets; 11/ electric power companies (in a variant of Otter Tail) have set high wholesale rates

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[7] See Standard Oil v. United States, 221 U.S. 1 (1911).

[8] See United States v. Terminal R.R. Ass'n, 224 U.S. 383 (1912).

[9] See Otter Tail Power Co. v. United States, 410 U.S. 366 (1973).

[10] United States v. Aluminum Co. of America, 148 F.2d 416 (2d Cir. 1945).

[11] Eastman Kodak v. Southern Photo Materials Co., 273 U.S. 359 (1927).

to convince potential entrant municipal retailers that it would not pay to enter the retail market. 12/

A third practice of the integrated monopolist seeking to adversely affect competition in other markets involves manipulation of product marketing and design. These cases are more controversial, however, because many believe (and the courts have so found) that the net benefits of the monopolist's behavior in product introduction cases have outweighed the costs. For example, IBM, facing competition in peripheral equipment compatible with its central processing units, redesigned the "plug" to thwart compatability and redesigned the CPU to integrate free-standing competing equipment. 13/ Eastman Kodak, a film monopolist facing a decline in its amateur camera market position, introduced a new size film simultaneously with a new size camera to fit it (and changed the development process of the film to disadvantage competing processors while it was at it!) 14/ Such product marketing and design practices did offer some advantages to consumers, primarily in the form of improved products, but they also were structured to disadvantage competitors and shore-up market control. Vertical integration between monopolized and competitive stages gives the firm an advantage its non-integrated competitors cannot match.

The fourth practice is market foreclosure. The integrated firm with market power at one stage may favor its own suppliers (or retailers) over competitors, thereby foreclosing competitive opportunities in markets where competition could exist. For example, Volkswagen did this in the airconditioner business, acquiring both a manufacturer of airconditioners for rear-cooled automobiles and the largest independent wholesale distributor of Volkswagen cars and parts. 15/ Other airconditioner manufacturers were then foreclosed from this market. GTE did this in the telephone equipment market, where its operating companies refused to purchase from outside suppliers. 16/

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[12] See City of Mishewaka v. American Elec. Power Co., 616 F.2d 976 (7th Cir. 1980), cert. denied, 101 S.Ct. 892 (1981).

[13] See, e.g., California Computer Prods. v. International Business Machines Corp., 613 F.2d 727 (9th Cir. 1979) (no violation).

[14] See Berkey Photo, Inc. v. Eastman Kodak Co., 603 F.2d 263 (2d Cir. 1979), cert. denied, 444 U.S. 1093 (1980).

[15] See Calnetics Corp. v. Volkswagen, 532 F.2d 674 (9th Cir.), cert. denied, 429 U.S. 940 (1976).

[16] See ITT v. General Tel. & Elec. Corp., 449 F.Supp. 1158 (D. Haw. 1978).

This had an effect in the non-AT&T equipment market. Nevertheless, many dispute whether competition is adversely affected by such foreclosure, or merely competitors. Integrated firms do seem to favor themselves. Whether the result is inefficient may depend on how easy it is to enter the competitive market and how willing a particular monopolist is to purchase better products from outsiders.

These cases demonstrate that whatever economic theory might predict in terms of the incentive for vertical integration, firms with monopoly power at one level of the production process have not been content to rest there. They have vertically integrated, and then engaged in refusals to deal, price squeezing, product manipulation, and market foreclosure. Through these practices, single-stage monopolists have sought to exploit their power by upsetting competition at other levels and gaining greater control over the entire manufacturing-distribution process. Although it cannot be denied that vertical integration (or horizontal integration for that matter) can result in manufacturing or transactional economies, the observed behavior of these integrated single-stage monopoly firms does not indicate efficiency related behavior, but rather efforts to preserve and extend monopoly power.

3. The Regulated-Unregulated Monopolist.

The concerns about the willingness of monopoly firms to use their power in competitive markets are accentuated where the firm is a regulated monopoly simultaneously operating in unregulated competitive markets. The incentive to use monopoly power comes from the desire to avoid the earning ceilings which rate regulation attempts to impose. The methods are obvious: The first is transfer pricing. The regulated monopolist can circumvent price controls by pricing at a high level the inputs it produces in its unregulated division. This phenomemon has manifested itself, of course, in the telephone industry and has led regulatory agencies to investigate the pricing and profits of Western Electric, a difficult task. 17/ The second is output pricing. Where the regulated monopolist produces regulated and unregulated ouput, the incentives are to allocate as much of the joint or common costs to the regulated side (thereby exploiting

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[17] See, e.g., Illinois Bell Tel. Co. v. Illinois Commerce Comm'n, 55 Ill. 2d 461, 303 N.E. 2d 364 (1973).

unused monopoly power). These costs are then passed on to the captive customer; lower prices are offered on the unregulated side, making competition difficult. These allocations can disadvantage competitors even if the regulated firm is scrupulous, because the allocations often raise complex conceptual problems (e.g. how much does otherwise unused computer time cost?).

There is a second concern when regulated monopolists operate in unregulated markets, one that is perhaps less widely acknowledged. This is the problem of managerial skills and the allocation of scarce managerial resources. Managers of regulated monopolists do not always do well in the unregulated environment; these efforts may drain scarce managerial time and effort. This has been the result, for example, in recent electric company acquisitions of coal producers. Although one would have expected production economies to have resulted from integration of this necessary input, managerial diseconomies have led power companies to reevaluate the benefits of this integration. 18/ In addition to managerial diseconomies, the lure of unregulated profits (or even the novelty of a competitive business) may cause reallocation of scarce management resources (as well as capital resources) away from the regulated service to the unregulated. The Penn Central's diversification efforts highlight this concern. 19/ It is difficult enough to spur the regulated monopolist to perform what is often a vital service in an innovative and efficient way. One should think carefully before creating any additional disincentives.

III. SHOULD AT&T BE ALLOWED TO OPERATE IN UNREGULATED MARKETS ON A FULLY INTEGRATED BASIS?

1. The Benefits of Full Integration.

AT&T has always claimed economic benefits from the integration in the Bell system of research, manufacturing, long-distance and local telephone operation. It is hard to say that this claim is totally without merit. On its face, the technical complexities and the scope of the telephone system seem to invite an intra-firm solution

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[18] See Brooks & Rhyne, Utility Performance With Captive Coal Companies, 108 P.U.F. 19 (July2,1981); Allen, Who Is Captive When Utilities Buy Coal Companies, 103 P.U.F. 16 (Jan. 4, 1979).

[19] See Daughen & Binzen, The Wreck of the Penn Central 242-51 (1971).

for at least some design and operation activities, thereby assuring technical compatability and avoiding conflicting financial interests. 20/ To the efficiency benefits of vertical integration must be added at least some competitive benefits if AT&T is allowed to expand into new unregulated markets. The 1956 consent decree restricts AT&T to regulated communications service. Allowing AT&T to enter unregulated markets would add competition to markets, a normally welcomed event. AT&T has tremendous capability in research, in the manufacture of equipment, in access to peoples' homes. AT&T would be a formidable competitor in the current markets for data processing, or cable television programming, or home security systems, or in the future markets for electronic newspapers or two-way selling.

2. The Costs of Full Integration.

It is undeniable that a fully-integrated AT&T operating in unregulated markets, particularly markets where it is a new entrant, is likely to provide some economic benefit. It is also difficult to avoid the conclusion that the fully-integrated offering of unregulated services by AT&T poses so many problems that its likely costs will far outweigh the benefits.

First, a fully-integrated AT&T with monopoly power in at least some of its transmission and switching links and with its dominant position in research and manufacturing, is likely to use its power to affect competition in currently competitive markets. Vertical integration would give AT&T access to information, both technical and marketing, that would give its unregulated operations a tremendous competitive advantage. AT&T would be unlikely to share information; indeed, it claims the close interaction among various divisions as a principal benefit of integration. The unregulated operations would benefit from AT&T's unparalleled access to capital markets.21/ Opportunities would abound for improper cost allocations between regulated and unregulated operations for jointly used physical facilities, technology use, shared managerial resources, and package sales of equipment and services. Price squeezing on transmission links for data processors could occur. 22/ Can we expect AT&T to license Bell

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[20] See Kahn, supra note 5, at 290-305.

[21] See N.Y. Times, Mar. 10, 1981, p. D9 (public sale of $600 million of 10-year notes).

[22] See Kahn, supra note 5, at 146 n. 93.

Labs' technology to outsiders? to sell Western Electric products to competing customer-premises equipment manufacturers or retailers? to allow a truly competitive equipment market to develop by buying from outside suppliers?

Not only is such behavior predictable from the market structure of a fully-integrated AT&T. It is also predictable from AT&T's own past behavior. In recent cases juries have convicted AT&T of a variety of monopolizing acts, primarily relating to refusals to deal (involving interconnection with potentially competing specialized carriers) and manipulation of product designs (to prevent interconnection). 23/ And AT&T is notorious in its unwillingness to use outside suppliers. One such supplier recently described AT&T's practice of comparing outside and in-house products this way: "'It's like a competition between you and God . . .'" 24/

Finally, I think we have to ask whether AT&T's managers don't have enough to do running the phone system. It is certainly understandable that as they have been hit by unaccustomed-to competition, they would like the opportunity to hit back. No doubt it wounds their pride to be thought of as a stodgy, unrisky company confined to protected monopoly markets. They would rather be thought of as "agressive"--the complimentary watchword of the 1980's. But here I think we need to heed the views of Louis Brandeis that firms can get too large for careful management 25/ (in modern jargon, people exhibit "bounded rationality" 26/). AT&T managers cannot attend everything at once. What will they slight?

IV. IS THE FSA OR DIVESTITURE THE SOLUTION?

1. The FSA

S. 898 accepts the view that the predictable costs of a fully-

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[23] See Litton System, Inc. v. AT&T, No.76 Civ.2512(WCC)(S.D.N.Y. June 29, 1981)(jury verdict for plaintiff and award of $92.3 million for conduct relating to interconnection device); MCI Communications Corp. v. AT&T, No. 746-633(N.D.Ill. 1980)(jury award of $1.8 billion)(on appeal); Northeastern Tel. Co. v. AT&T, 1981-1 Trade Cas. ¶64, 027 (2d Cir. 1981)(reversing jury award on predatory pricing claim; claim that AT&T designed protective coupler in unreasonable manner "is not totally unsubstantiated" and is remanded for new trial).

[24] See Chace, "Outside Suppliers find that Ringing Up Sales With With AT&T Isn't Easy," Wall St. Journal, Jan. 29, 1981, p.1.

[25] See Brandeis,"Competition," in The Curse of Bigness 116-17 (O. Fraenkel ed. 1934).

[26] See H. Simon, Models of Man: Social and Rational 198(1957).

integrated AT&T, operating in regulated and unregulated markets, would outweigh the benefits. The bill's approach is to allow the creation of a fully separated affiliate (FSA) to perform AT&T's unregulated operations. This sounds like a sensible compromise between keeping AT&T out and no-holds-barred entry, one already accepted by the FCC for AT&T 27/ and (in 1971) for General Telephone's entry into data processing. 28/ But the concept has two inherent flaws: 1) the more separate the affiliate, the less reason there is for common ownership, particularly where efforts are made to provide outsiders with information that will allow them to provide compatible products; 2) affiliation still inevitably provides incentives for favoritsm which will require resources to police. Examination of the concept as operationalized in S. 898 reveals both flaws: loss of the reasons for common ownership, and the imposition of the costs of regulation. Further, to the extent that the affiliate has not truly been separated, the bill then fails to cure the problems mentioned earlier arising out of vertical integration by a regulated monopolist, problems which form the basis for deciding not to allow entry on a fully integrated basis.

S. 898 attempts to assure "full separateness" in two ways. First are certain requirements of non-discriminatory and open dealing by the regulated enterprise. The Bell regulated entity (BRE) is required to provide non-discriminatory interconnection on request, both for carriers and customer-premises equipment (§207), and to offer any regulated telecommunications service "upon reasonable request" (§208). AT&T is also required to reveal information about its operations as required by the FCC (§209), specifically including operational protocols and technical interface requirements (which cannot be predisclosed to the FSA)(§§214 (g)(1)(A),(B). The second method for insuring separateness is to monitor dealings between the BRE and the FSA. These provisions are fairly extensive. The FCC has authority to regulate AT&T (but not the FSA) to deal with anticompetitive practices between the two (§202(c)(1)); a variety of BRE-FSA business

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[27] See In the Matter of Amendment of Section 64.702 of the Commission's Rules and Regulations (Second Computer Inquiry), 47 R.R.2d 669, as amended, 48 R.R.2d 1107 (1980).

[28] See Regulatory & Policy Problems Presented by the Interdependence of Computer & Communications Services & Facilities, 28 FCC 2d (1971), aff'd in part sub nom.,GTE Service Corp. v. FCC, 474 F.2d 724 (2d Cir. 1973).

arrangements must be reported to the Commission (e.g. sales of property, lending of money, furnishing of services); these arrangements must be "on a fully auditable and compensatory basis" (§227 (b)); BRE-FSA business dealings should not include "any preference or discrimination arising out of affiliation" (§227(c)); BRE and FSA cannot own property jointly or engage in joint sales or marketing efforts other than advertising (§227(d)).

These provisions appear to have adequately solved only one of the likely vertical integration problems I mentioned earlier--refusals to deal. The other concerns are less well addressed. Uniform pricing does not prevent price squeezes, unless the Commission determines that the price is generally "unreasonable" (i.e. excessively high) (see §208), which may be a difficult task. The open dealing requirements of §214 may avoid some technical manipulations of the system in a way that might favor the FSA, another practice of the vertically integrated monopolist, but the provisions do not begin to solve the complex problems involved, particularly with respect to planning. It is one thing to forbid predisclosure to the FSA of final operating protocols or interface requirements. But will the FSA help shape final decisions? If so, the FSA will obtain a competitive advantage not open to other firms. If not--if §214 requires AT&T to plan in public, thereby avoiding intra-firm transactional economies --then what reason is there for the FSA to be affiliated at all? Viewed either way the FSA concept fails. The lengthy provisions regulating agreements between the regulated entity and the FSA simply punt on the difficult costing problems. What is a "compensatory basis" for BRE-FSA dealings? Will computer time be sold on a short-run marginal cost basis? What will be the cost of (equity? debt?) capital BRE furnishes the FSA? What happens if the FSA defaults? If an AT&T operating company touts FSA consumer premises equipment in a billing insert, how much will the FSA pay? Opportunities for manipulation are rife. Finally, the other two concerns I mentioned earlier --market foreclosure and managerial resource misallocation--are not remedied at all. No provisions attempt to open BRE to non-affiliated suppliers, a step the FCC still thinks necessary even after its decision allowing AT&T to form FSA's 29/; having unregulated activities performed by an affiliate, separated or not, will obviously consume managerial resources (as is explicitly acknowledged in §202 (d)).

There is a deeper problem. The thrust of the bill is to contain the monopoly power of the BRE. Left untouched is Western Electric, and the dealings between Western Electric, Bell Labs, and the future data processing and customer premises equipment marketing divisions. The bill does not open Bell Labs' capabilities to outside companies. Western Electric has significant market power in the manufacturing of telecommunications equipment. It is using it right now to thwart tommorrow's competition in customer-premises equipment. 30/ The bill does nothing to interfere with this position. In fact, affiliation alone (without regard to the ultimate construction of §214) will provide Western Electric with a close tie to the rest of AT&T, a relationship unavailable to non-affiliated manufacturers. Bell Labs, Western Electric, and the data processing and marketing FSA's will form an integrated powerhouse, necessarily in service to AT&T's needs by virtue of common ownership.

On top of the bill's failure to truly separate AT&T and avoid predictable vertical integration problems, the bill exacts high regulatory costs. It gives the FCC numerous directives for policing the affiliation and preventing abuse, but these directions are poorly defined and cumbersome. Examples: What is "commerical information" whose provision would give the FSA an "unfair" competitive advantage (§227(f))? How is the Commission to determine that BRE-FSA business is carried out in the same manner as BRE-non-affiliated business (§227(c))? The Commission is given a broad range of FSA-BRE transactions to audit in §227. An eight year transition of Western Electric and Bell Labs into an FSA must be overseen. The time-table requires the FCC to distinguish between final assemblies and subassemblies, and to, separate basic research from applied research (and "subassembly

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[29] See "FCC Pushes Staff Bid for Bell System to Buy More Gear From Independents," Wall St. Journal, July 15, 1981, p. 14 (proposal to establish procurement entity between operating companies and Western Electric to provide information to independent suppliers).

[30] See Chace, "AT&T's Price Tactics Prod Firms to Replace Old Phone Equipment," Wall St. Journal, April 24, 1981, p.1 (raising prices of older equipment to force customers to "migrate" to newer AT&T equipment before deregulation produces new equipment sources).

specific research")(see §228(c)). The FCC is directed to prescribe regulations for separate pricing of customer-premises equipment and information services "on a fair market value basis" (§234(b)(1)). How deeply will the FCC be required to go to determine fair market value of these products? How many separate products will be involved? Finally, it is to be expected that users of telecommunications services and competitors of AT&T are likely to complain to the Commission about alleged improper dealings and "anticompetitive practices" (not further defined)(see §202(c)) and about alleged failures to comply with the bill's anti-discrimination and disclosure requirements. All in all, the FCC is going to be very busy.

So long as the affiliate is affiliated there will be an incentive for AT&T to favor it. Regulation will be required. Even well-drafted regulation imposes costs. These regulations are not well drafted and will impose high costs.

2. Why Not Divestiture?

The fully separate affiliate as established in S. 898 is fully affiliated, but it is not separate. Despite the imposition of substantial regulation, the FSA will still have a significant advantage over its competitors. It will have AT&T's access to capital markets; it will have at least some access to AT&T's future operating plans; in combination with Western Electric and Bell Labs it will have access to equipment and technology; and it will have access to a most valuable customer, AT&T. Added to the bill's failure to alter significantly AT&T's anticompetitive structure, S. 898 will require the FCC to engage in continuing oversight of the relations between BRE and the FSA(s).

The FSA offers no benefits and high costs.The question is, why establish such a system? Once we acknowledge that full integration poses excessive competitive risks, the proper solution should be divestiture,not an un-fully separated affiliate.

Divesting the parts of AT&T which are to go into an FSA--Western Electric, Bell Labs, data processing, customer-premises equipment--would: 1) end market foreclosure by opening up AT&T's needs to outsiders (including its needs for data processing); 2) eliminate the need for complicated provisions to avoid discriminatory dealings by eliminating the incentives for such dealings; 3) eliminate the concern over transfer pricing and price sequeezes by eliminating incentives to extend monopoly power; 4) free Western Electric and Bell Labs to sell their services to other firms, making them into new competitive forces. There would then be no need to confine the spun-off firms to data processing and consumer premises equipment. Shorn of AT&T's monopoly power--and its overwhelming size--these companies should then be free to enter and compete in other fields, including cable and mass media.

It is no wonder that the management of AT&T likes this bill. They can keep Western Electric, keep Bell Labs, enter a new market formerly closed. Newspaper and cable interests no doubt also prefer the FSA structure to divestiture. They have used the Congress to exclude a powerful competitor from their markets. Teachers of regulated industries will like it too, because it will provide a new regulatory scheme to teach and explore. (Perhaps even the FCC appreciates the business.) But who else? Shareholders would probably be better off owning AT&T in pieces. The public would be better off with full-fledged competition. AT&T has estimated that to organize the FSA projected by the FCC (for customer-premises equipment and enhanced services), it will transfer over $10 billion in assets and 100,000 employees. 31/ A firm of this magnitude would be the 17th largest industrial corporation in the United States (by assets), just ahead of Conoco. Why have it wedded to AT&T?

This is not a deregulation bill. This is not a bill which is as procompetitive as it could be. In comparison to the complicated structure envisioned, the total separation of AT&T's regulated and unregulated parts would be simpler and would not require regulatory monitoring. Divestiture is preferrable public policy. I urge this Committee to adopt it.

Thank you.

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[31] See Brief of the Department of Justice Opposing AT&T Interpretation of 1956 Consent Decree, printed in Legal Times of Washington, April 20, 1981, p. 16.

PREPARED STATEMENT OF PROF. ROBERT D. WILLIG

Thank you for giving me the honor and privilege of testifying on the proposed Telecommunications Competition and Deregulation Act of 1981. I will structure my remarks around the provisions of S898, as I understand them from my reading of Staff Draft No. 3.

In my opinion, it is a good bill in many regards. It shows sensitivity to most of the elements of the public interest that have concerned objective observers. It is based on findings that accurately reflect years of policy studies and analyses. And the bill embodies genuine attempts to resolve the many conflicts and dilemmas that beset its drafters.

Nonetheless, I feel there are several areas in which alterations of the bill might well serve the public interest. These areas are:

(1) The relationship between a fully separated affiliate and the rest of AT&T.

(2) Cable deregulation.

(3) The definition of effective competition.

(4) Exchange access.

(5) "Regulated oligopoly."

I shall briefly discuss my concerns in each of these areas.

Fully Separated Affiliate

There is a fundamental conflict in the formulation of policy towards the telecommunications industry. While many basic telephone services should clearly remain regulated, because of conditions of natural monopoly and prohibitive entry barriers, many other telecommunications products and services could be sold competitively, with the consequent overriding social benefits of progressivity and market discipline. The expertise, organization, personnel, and assets of AT&T could be productively applied to the supply of all these goods. Yet, any firm that supplies both regulated and unregulated goods must have powerful incentives to divert revenues towards its unregulated operations and costs towards its regulated ones. The unfortunate results of such diversions are anti-competitive advantages in unregulated markets and inefficient and unfair high prices for regulated services.

As I read it, S898 attempts to resolve this fundamental conflict by permitting AT&T to operate in unregulated markets through a deregulated fully separated affiliate (FSA). A number of conditions are specified with the purpose, I presume, of ensuring that the regulated remainder of AT&T (henceforth just "AT&T") confers no advantages on the FSA that are anti-competitive vis-a-vis its rivals. These conditions reach their fullest constraint after a 6-year transition period. Relationships between AT&T and the FSA are to be overseen by the FCC.

In assessing these provisions of the bill, one must consider the alternatives. The conditions could be made more or less constraining on relations between AT&T and the FSA, or AT&T could be forced to divest the FSA after a suitable transition period. It is clear that some one of these alternatives, or the provisions of the proposed bill, is preferable to the extreme measures of precluding either the Bell System or its rivals from the supply of potentially competitive telecommunications products and services.

However, it is also clear, I am prepared to argue, that the present version of S898 leaves open opportunities for substantial cross-subsidization of competitive activities by AT&T's regulated services, and opportunities for the conferral of anti-competitive advantages on AT&T's FSA. Further, under the provisions of S898, AT&T would have financial incentives to engage in such practices. Moreover, the bill would make the FCC responsible for a host of new policing functions -- functions that would, I predict, lead to regulatory quagmires and uncertainty like those that have plagued the industry over the past decade. Nonetheless, I cannot conclude from this assessment alone that the public interest would be best served by stricter conditions or by eventual divestiture of the FSA. It may be the case that coordination between AT&T and the FSA would generate cost savings from economies of scope sufficiently large to outweigh any predicted anti-competitive effects and regulatory tangles. On this point, surely, the burden of proof falls to AT&T.

If coordination between AT&T and its FSA would generate no substantial savings in social costs, other than those available through mutually advantageous contracts and market transactions, then eventual divestiture would be best. The reasons are that AT&T would have no incentive to confer anti-competitive advantages on a divested former FSA, that divestiture would minimize (but by no means eliminate) regulatory tangles, and that, as hypothesized, the divestiture would sacrifice no substantial savings in social costs. On the other hand, if some elements of non-market coordination between AT&T and its FSA can be established to generate substantial savings in social costs, then divestiture may be too costly. Rather, conditions should be chosen that balance the control of any anti-competitive conduct against opportunities for socially beneficial coordination.

Unfortunately, I do not have enough information to reach a more useful conclusion. However, I would like to emphasize that S898, as it is presently written, does seem to leave much room for coordination between AT&T and its FSA. This can be consistent with the public interest only if the permitted coordination can effect cost savings not otherwise available. Even so, they may not be worth the resulting anti-competitive effects and regulatory tangle.

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I will now briefly sketch some of the arguments to which I alluded above. A partially regulated firm can raise its total profit by shifting costs to its regulated operations and by shifting revenues to its unregulated portion. The diverted costs can be recovered from the increases in regulated prices that would be approved so as to permit the firm to regain its allowed rate of return on its regulated services. The diverted revenues would simply augment the unconstrained profits earned by the firm on its unregulated activities.

Profitable manipulations of this kind are anti-competitive in at least two different and fundamental ways. First, anti-competitive cross-subsidization entails shifting away costs of competitive operations; pricing or threatening to price competitive offerings below true costs, but above the costs that remain unshifted; and thereby diverting sales from rivals whose costs may be below the true costs of the partially regulated firm. The result of this tactic are diminished competition and increased industry-wide cost that is borne by the consumers of the regulated services. Second, conferral of anti-competitive advantages entails unprofitable actions by the regulated portion of the firm that advantage the unregulated portion and disadvantage that portion's rivals. While these actions are unprofitable for the regulated portion, they are profitable for the firm as a whole, as explained above. This tactic increments monopoly power in the unregulated markets and raises industry-wide costs. Ill effects may be felt by consumers of both the regulated and unregulated services.

S898 affords AT&T significant opportunities to engage in both types of anti-competitive conduct. The opportunities for anti-competitive cross-subsidies are most obvious. The bill places almost no restrictions on activities undertaken jointly by AT&T and its FSA with regard to foreign sales or national security. Consequently, substantial fixed and common costs of R&D and manufacture could be attributed to such joint activities, with a preponderant share borne by AT&T. However, a preponderant share of the benefits of these activities could be enjoyed by the FSA in its domestic commercial operations. For example, it would be relatively inexpensive to adapt for the domestic market a novel piece of equipment first brought to European markets. The FSA would expend relatively little and gain the revenues from the domestic sales of the equipment, much of whose costs were anti-competitively cross-subsidized by AT&T.

Similarly, it appears that substantial opportunities for cross-subsidization are afforded by the silence of the bill on the subject of basic research. Further, to the extent that the line between basic research and product-specific R&D is hazy, even the latter would be open to cross-subsidization, Section 228(f)(3) notwithstanding.

In general, the bill permits AT&T to undertake a host of activities for the FSA, "on a fully auditable and compensatory basis" (Section 227(b)). While this standard is the correct one, in principle, it will be subject to substantial manipulation whenever the activity in question is not generally marketed, and common or joint costs are involved. In these prevalent circumstances, there will be opportunity for anti-competitive cross-subsidization.

Wherever there is opportunity for cross-subsidization between AT&T and the FSA, there is incentive for rivals to ask for FCC investigation, under S898. Unfortunately, the record of the FCC in analogous investigations for cross-subsidies is fraught with interminable delays and findings that are often arbitrary or negotiated. (Of course, other regulatory bodies have fared little better with such difficult matters.) Hence, a dismal regulatory tangle is the extrapolation of this record to a much expanded load of cross-subsidy investigations.

S898 seems to afford AT&T ample opportunity to confer anti-competitive advantages on its FSA, despite the prohibition of "preference or discrimination arising out of affiliation" (Section 227 (c)). Contracts for AT&T's services can be drawn that are well suited and favorable to the FSA, but that would be unappealing to rivals because of the likelihood of expensive disputes or of disclosure of proprietary information. AT&T would have strong incentives to accommodate requests from the FSA for contractual services, facility utilization, or new network features needed to supply a new unregulated service or to support new terminal gear. And AT&T would have equally strong incentives to be unaccommodating to the rivals of the FSA. The FCC would have great difficulty in establishing unequal treatment inasmuch as the differences stemmed from employee attitudes or the requests were not directly comparable.

The provision of AT&T management services to the FSA and the presence of an AT&T person on the FSA board of directors (of whom 50% could be FSA officers) would assure the coordination of the entities' strategic planning, to the disadvantage of rivals who are dependent on AT&T's network. FCC oversight could not preclude the harmonizing of AT&T's expansion and alterations of its network with the FSA's needs for network services. And FCC oversight could not preclude AT&T from impeding or delaying network modifications complementary to rivals' goods and services. The resulting anti-competitive advantages conferred on the FSA could be substantial.

The bill seems to prescribe that AT&T and the FSA interact as if they were unaffiliated (Section 227 (c)), except with regard to foreign sales and national security. I have argued that this prescription will be unenforceable, as the bill is written. However, the question remains as to why S898 does not order the entities to actually be unaffiliated, rather than just act that way. If the only answer is the coordination needed for foreign sales and national security activities, then better approaches may be possible. For example, the FSA could be divested after a transition period, and a permanent joint venture created to pursue foreign sales and national security activities. Although I have not prepared analyses of such alternatives, they may merit consideration.

Cable Deregulation

As I read it, Section 204 would amend Section 202 of the 1934 Act to include Subsections (h) and (i) - which substantially affect the provision of cable television services. They proscribe Federal, state, or local regulation of prices charged by cable system operators, with two exceptions. One exception is public access channels. The other exception is a price for retransmitted broadcast signals, where it has been determined that there are no reasonably available alternatives.

In my view, these exceptions are far too narrow. They should be broadened to permit state or local regulation of any cable services for which there are no reasonably available alternatives and no effective competition. As such, prices for basic cable connection, pay TV programming, and two-way interactive cable services could be regulated if conditions so warranted.

The rationale for my view is straightforward. Cable television is presently a local natural monopoly protected by sunk-cost entry barriers. Total costs would be nearly doubled by having two firms compete for hooking-up homes in any given neighborhood. Equally important, an existing cable system is highly invulnerable to competitive entry because an entrant would have to sink the indivisible construction cost of an entire system before it could achieve any degree of market penetration. True, different geographical areas are often served by different cable system operators. However, almost nowhere do consumers now have a choice between two or more competing cable system operators.

This natural pattern of monopolization may change with time and technological advance. In the future, cable systems may face effective competition from firms that make use of forthcoming broadband telephone transmission facilities, direct broadcast satellite systems, line-of-sight microwave, or other technologies. It is clear that competition with cable systems will grow, and that the growth will proceed at different rates in different regions depending on their population density, terrain, and other characteristics.

It also seems clear, however, that unregulated cable systems could possess substantial monopoly power now, and could so continue for some time. This monopoly power could be exercised over prices, to the detriment of the public interest, in at least two ways. First, cable systems could elevate prices charged consumers for basic, pay, and new interactive cable services. Second, cable systems could anti-competitively discriminate in their service offerings, in the prices charged for different services and programs, and in the prices they pay providers of services and programs. Such discrimination would favor programming sold by corporate relatives of the cable system. It would diminish competition among programmers and vitiate consumer sovereignty over program options.

These problems have been and continue to be realities in the eyes of many observers. A substantial portion of cable consumers are now served by systems that are corporate relatives of program providers. Until recently, many of the largest cable systems were forbidden by their corporate parent from offering any pay TV service competitive with that owned by the parent. This trend has paused - in part because of actions taken by municipalities. Many new franchise agreements between municipalities and cable system operators have stipulated a list of program services that will be made available. Some of these agreements also include controls on prices charged for basic cable service, where permitted by the state. Elsewhere, it is the state that regulates basic cable prices. Needless to say, as written, S898 could preclude such attempts by municipalities and states to protect the interests of consumers and to control cable system monopoly power.

I do not mean, here, to advocate any particular form of cable regulation. Rather, I want to suggest that states and their political subdivisions should be left somewhat unregulated in their relationships with cable systems that are essentially local public utilities. However, deregulation of cable services would be appropriate where there are determined to be reasonably available alternatives or effective competition.

The Definition of Effective Competition

Section 205 of S898, which amends Section 203 of the 1934 Act, includes a definition of "effective competition" in Subsection (c)(2). In my view, it would be useful to add language explicitly stating that potential entry of new rivals and potential expansion of existing rivals can be sources of effective competition, even in markets that are concentrated.

For a hypothetical example, suppose that AT&T offers a particular private line service at a price near cost, and enjoys a 99% market share. Suppose, further, that if it raised its price, AT&T would lose substantial market share to new rivals who would enter the market and to old ones who would expand as a result of the price increase. Then, AT&T has no market power over the service, has no ability to elevate price, and is effectively constrained by potential entry or potential competition. Yet, it is not clear that the service would be found subject to "effective competition" under the definition given by the bill. Due to AT&T's hypothetical market share of 99%, a fact-finder might determine that there is no "reasonably available alternative." Nonetheless, such alternatives would be brought to market if AT&T raised its price, and deregulation of the service would be in the public interest.

Exchange Access

As I read the bill, it does not clearly stipulate that equal fees be charged for the exchange access of regulated interexchange services that are supplied by both the exchange carrier and its rivals. The public interest requires parity in the terms, technical conditions, and prices at which exchange access is made available to all potential rivals, including the exchange carrier itself. Only parity can assure that interexchange services are supplied by the most efficient carrier. Of course, apparent parity can be rendered a sham by arbitrary allocations of an exchange carrier's costs between exchange access and interexchange services. An exchange carrier may have financial incentive to allocate as much cost as possible to its exchange access service, and as little as possible to its more rivalrous interexchange services. By so doing, the exchange carrier can extract high fees from other carriers, while simply transferring the fees paid to itself from one pocket to another.

Socially efficient defrayal of the fixed costs of exchange facilities requires that the different services making use of them be permitted to contribute different levels of net revenues. Specifically, facility utilization and consumer welfare are increased by exchange access fees that are related to demands or to value of service as well as to costs. As such, the public interest would be served by adding language to the bill that would permit exchange access fees to be differentiated on the basis of use. Then, for example, the access fee levied for a five minute short-haul interexchange call could be less than that levied for a long-haul call of the same duration. Of course, such fees must apply to all interexchange carriers who request exchange access for similar uses.

Regulated Oligopoly

I am concerned about social inefficiencies in the supply of services which would be, under the bill, both regulated and sold under oligopoly conditions. For example, ordinary long distance calling between cities might well fall into this category if AT&T were to maintain a substantial market share, but if the rest of the market were served by smaller rivals.

In such cases, S898 might permit or even encourage behavior on the part of firms and the FCC that is contrary to the public interest. First, the FCC might perceive a mandate to (Section 203) "encourage the development of (effective) competition" by advantaging firms with smaller market shares, and disadvantaging firms with larger market shares. [e.g. see Section 220(e), "The Commission shall have due regard to the different sizes of carriers in prescribing forms or guidelines under this section."]

Second, under the bill, the FCC would certainly have the power to act as a handicapper among oligopolistic rivals in markets for regulated services. It could essentially allocate or adjust market shares by means of its authority over tariffs for regulated services. It could allocate or adjust rivals' shares of total market capacity by means of its power to certificate, or not to certificate, any (Section 214(b)(1), as amended by Section 216) "new or extended interexchange transmission facility" of a dominant regulated carrier. And, it is possible that the bill would permit the Commission to establish an effectively discriminatory system of fees for the exchange access needed for regulated interexchange services. For example, both the Bell System and its rivals argue that the present ENFIA tariffs discriminate against themselves. FCC staff papers argue that the ENFIA tariffs should advantage Bell's rivals, so as to encourage competition.

Third, regulated rivals would have incentives to appear as affected parties in one another's tariff proceedings, in attempts to stifle competitive price responses. As a result, the FCC might act as a mediator between rivals, with prices set essentially by negotiation and compromise.

All of the behavior just described is contrary to the public interest. Where market shares, capacity levels, access fees, and output prices are influenced by negotiations and attempts to handicap rivals, social inefficiencies result. These take the form of higher industry costs, higher industry prices, and less industry output. Social efficiency is obtained by market competition between rivals, not regulatory allocation.

Small alterations in the bill may help avoid the inefficiencies of regulated oligopoly. The FCC should be directed to promote competition, without handicapping competitors. It should be directed to oversee tariffs, exchange access fees and facility construction, without regard for market share and competitive position. The bill should stipulate that tariffs be established to promote the efficient utilization of the nation's telecommunications resources. In contrast, S898 only echoes the 1934 Act in calling for "just, reasonable, and nondiscriminatory tariffs..." (Section 210, creating a new Section 208 for the 1934 Act). And deregulation of services supplied by an oligopoly, even if they are basic telephone services, can be encouraged by appropriate broadening of the definition of effective competition, as noted above.

PREPARED STATEMENT OF CARL O. THORSEN

Mr. Chairman and Members of the Committee:

My name is Carl O. Thorsen. I am Chief Communications Rates Analyst for the New York State Department of Public Service. I am speaking today on behalf of Neil A. Swift, Director of the Communications Division for the New York State Department of Public Service. We are pleased to have the opportunity to address this Committee with respect to cross-subsidization and the safeguards contained in S. 898 designed to minimize the potential for cost and price manipulation.

I represent a state that has actively advocated and encouraged competition and deregulation in the communications industry. We were the first state to authorize the use of a simple and inexpensive network protective device; the first to establish an equipment certification program; and the first to permit residence customers to own and provide their own premises wiring. This year, legislation was introduced to permit the Public Service Commission discretion selectively to regulate or deregulate aspects of the telecommunications industry. Legislation was also introduced to deregulate the radio-telephone industry, and to deregulate the telegraph industry. The latter Bill was signed into law this month.

Because of our aggressive stand on competition and deregulation, we have been very sensitive to the need for sound procedures necessary to guard against cross-subsidies. My comments, therefore, will primarily detail the experience in New York with cross-subsidization in competitive markets and the relationship of our experience to the proposals in S. 898.

As a preface, I would like to cite Section 201 - Statement of Policy - of the proposed legislation which states:

> "Where competition does not now exist, it is the policy of the United States to encourage the development of such competition and pursuant to an appropriate transition in accordance with this Act, to deregulate telecommunications services while establishing appropriate safeguards to prevent anti-competitive practices..."

It is essential to distinguish between anti-competitive practices and permissible cross-subsidization before proceeding further. It is possible to engage in cross-subsidy without being anti-competitive. It is quite common, for example, for the business community to retail with a greater price mark-up on luxuries than on daily essentials. Whether it is hamburger versus filet mignon, rebates on selected automobiles, or the daily occurrence of a sale, some form of inter-product cross-subsidy is an essential marketing tool and generally is not construed to be anti-competitive. Frequently, the technique is no more than the assignment of common or joint overheads to the product most able to either withstand the mark-up at the time or in the long run. Sometimes, there are genuine loss leaders sold below their marginal costs.

However, cross-subsidy of competitive markets by monopoly services is anti-competitive and requires preventive measures to avoid. It is this form of cross-subsidy that must be prevented and it is this area in which New York has concentrated much effort.

One of the first actions required of the FCC by the proposed legislation is the prescription of guidelines relating to accounts and records designed at a minimum to accomplish a complete allocation of all revenues and costs, including joint and common costs, between regulated goods and services and unregulated goods and services [Section 220(a)(2)]. These reporting requirements would apply to all regulated carriers, including the dominant regulated carrier, until a fully separated affiliate is established to provide unregulated goods and services. The steps we have taken in New York in large measure parallel the objectives of Section 220. We have been able to disaggregate the investment and costs associated with competitive product lines and, despite comments to the contrary by industry spokesmen, we have found "subsidies."

In 1973, the Staff of the Commission undertook a study of the profitability of New York Telephone Company's customer premise equipment, including inside wiring. The Staff decided that the best method to measure customer premises equipment costs would involve the use of actual company investment, expense, and revenues taken directly from the company's books. The Uniform System of Accounts prescribed by the New York Commission and the FCC, with some special analysis, enabled us to accomplish this purpose. The results of this 1973 study were submitted to the Commission in the context of a formal rate proceeding. After several modifications by the Commission, the Commission itself found that New York Telephone's customer premises equipment revenues were some $225 million less than the customer premises equipment costs. This represented a 39 percent revenue deficiency on an embedded equipment basis.

The review is now performed with each rate increase request, and three major modifications have been incorporated in the calculation of customer premises equipment costs. First, to reflect the fair value of the apparatus, the New York Commission has required that the equipment be priced on the basis of current cost. The true worth of the apparatus is then reflected in the price and the potential price advantage associated with lower embedded costs is eliminated. The second adjustment is the imputation of a higher cost of equity to competitive services. This imputation recognizes the difference of the competitive market versus the monopoly market. Lastly, the analysis is performed on the basis of costs projected one year into the future, the period for which prices will likely remain stable. This last step is, we believe, essential to the promotion of fair competition.

Our reviews are not limited solely to customer premises equipment or to the New York Telephone Company. We have reviewed competitive service lines for all of the larger telephone companies operating in New York, and many of the small independents. More often than not, we have found that the revenues from competitive lines of business are inadequate to cover the identified costs. And, in each instance, we have required the appropriate price increase necessary to eliminate or substantially diminish the identified deficiencies.

Our regulation of the communications industry has required the cost separation for analysis of competitive and non-competitive lines of business. We believe the measures we have adopted are effective in identifying and eliminating subsidies and achieve the same result as Section 220 of the proposed legislation. The effectiveness of our actions in fostering competition are evidenced by the fact that approximately one-third of all business telephone lines in New York utilize equipment provided by someone other than a telephone company.

However, the potential for cross-subsidization and the harm that can occur from anti-competitive practices of a dominant company require special attention. Indeed, the legislation recognizes the need for further measures and calls for the establishment of a fully-separated affiliate(s) to provide non-regulated services. This measure reduces further the possibility of cross-subsidization. The requirement that there be no employees in common between the regulated dominant carrier and the fully-separated affiliate, the requirement for separate books, and the requirement that all transactions between the dominant carrier and the fully separate affiliate be fully auditable are additional safeguards to minimize the opportunity for cross-subsidy. The FCC's Computer II decision reinforces the preference for a fully separated affiliate from a regulatory standpoint.

In New York State, we have had experience with affiliates that are not fully separate which support the preference for full separation. Rochester Telephone Corporation, for example, has established a subsidiary to conduct unregulated activities which include the sale and refurbishment of equipment and the offering of consulting engineering expertise. Employees of the regulated entity have, on occasion, performed special tasks or engineering studies for the unregulated affiliate. Competitors have claimed that the compensation to the regulated carrier for its services does not reflect all of the appropriate costs and that a pool of personnel dedicated to monopoly services but available to the unregulated affiliate on an as needed basis provides a distinct advantage to the unregulated affiliate. These allegations and potential difficulties are avoided when a fully separate affiliate is established.

One area of particular sensitivity and one common to most corporations with fully separated affiliates is the transfer of personnel. The concern has been raised that monopoly ratepayers could finance the development and training of employees who in turn would be transferred to the fully-separated affiliate. In addition, employees of the dominant carrier with specialized marketing information or customer contacts could be transferred to the unregulated affiliate. In New York, this occurrence has resulted in claims of anti-competitive behavior. And, even if none is intended, it has the appearance of being anti-competitive. New York State has attempted to resolve this issue without restricting employee transfer opportunities -- a restriction we do not in any way endorse. We have been able with the participation of the regulated carrier to obtain assurances that, for example, a transferred employee would not be assigned to the same accounts when accepting a position with the unregulated affiliate. Guidelines and procedures have even been issued by the corporation to outline proper professional conduct in dealing with employees of the unregulated affiliate. While there are no guaranteed safeguards against anti-competitive behavior, we have been able to deal with this kind of problem, and review and resolve claims on a case by case basis.

The transition to a competitive communications market is accompanied by a plan requiring AT&T to establish fully separate affiliates relating to research, development, and manufacturing activities. The transition to the new corporate structure is staged at four, six, and eight year intervals. During this transition period, services or equipment are to be furnished to any fully separated affiliate for an amount which is fully compensatory and not less than the charges for which similar services and equipment would be or are transferred in the marketplace between non-affiliates.

The New York Commission has had a long standing concern about the intra-corporate relationships between New York Telephone and AT&T and the opportunity for subsidies from monopoly customers to customers of competitive services offered now or in the future by New York Telephone or an unregulated subsidiary.

The New York Commission has, for example, recognized that Western Electric achieves a price advantage over its competitors because the cost associated with applied research, quality assurance, and patent work is treated as an operating expense to be covered by license contract revenues. The Commission believes these expenditures should be reflected in Western Electric's product prices as would be the case for other firms. A firm engaged only in the business of manufacturing telecommunications equipment, for example, must reflect research cost in its product prices since it has no other source of revenue.

During the transition period, it will be necessary to insure that the relationship between the dominant carrier and the manufacturing, research, and development affiliates of AT&T does not leave open the opportunity for unwarranted advantages because of the temporary continuance of the integrated corporate structure. However, we would not expect, after enactment of the legislation, that it would be permissible to use license contract fees to offset the costs of product manufacture or development. Therefore, while the opportunity for cross-subsidy or anti-competitive practices may exist during the transition, we believe it will be lessened since only contracts for service should remain. So long as these arrangements are auditable, we will be able to maintain surveillance, as we have in the past, and guard against possible cross-subsidy.

The responsibility for implementing and overseeing the provisions of the legislation, if enacted, will rest with the Federal Communications Commission and state regulators. It is readily apparent first and foremost that fair competition in the development, manufacture, and marketing of telephone services must be insured. While it is not possible to fully guarantee that there will be no cross-subsidies or anti-competitive practices, we believe that the proposed legislation offers a comprehensive and effective means of minimizing the opportunity, potential, and incentive for such activity. Any difficulties with AT&T that arise during implementation should be resolved primarily by the FCC. We believe that we are equipped to continue to deal effectively with non-dominant companies and that improvements in accountability, such as the separation of costs for bookkeeping purposes, will enhance the monitoring efforts and reduce further the chances for cross-subsidization of competitive products by monopoly services.

The telecommunications industry is booming and despite recent private anti-trust verdicts against AT&T, we are optimistic about the progress already made by relatively small firms in competing against what for many decades was a one hundred percent end to end legal monopoly market. We believe S. 898 provides reasonable opportunities for more competition, less regulation but, at the same time, reasonable safeguards for monopoly ratepayers and competitors.

Senator SPECTER. We welcome Mr. John Mason, Mr. Edwin Kilburn, and Mr. Thomas Thompson.

Mr. Mason is president of Valcom, Inc., of Roanoke, Va., which he formed in 1977, a company which manufactures telecommunications products that fill special needs of telephone operating companies.

Valcom, like other small and medium-sized general trade manufacturers, competes with Western Electric for a portion of the apparatus and equipment business of the Bell operating companies.

We welcome you, Mr. Mason.

I would repeat that your statement will be made a part of the record.

I might begin with a question as to how successful you are in competing with Western Electric for equipment business of the Bell operating companies.

STATEMENT OF JOHN MASON, PRESIDENT, VALCOM, INC., ROANOKE, VA.

Mr. MASON. In situations where we compete absolutely directly, very unsuccessful. This is a very common condition of general trade manufacturers.

Senator SPECTER. The information I have says that Valcom competes with Western Electric for a portion of the equipment business of Bell operating companies.

Mr. MASON. Yes, sir.

I would like to give you an example. We make an off-premise station adapter device to allow single line station types of——

Senator SPECTER. Western does not make that?

Mr. MASON. They have not made it in the past. We have been used in some operating companies. It is our understanding recently that Western is about to introduce one in September. At that time, they will stop using our devices and the operating companies are doing so.

Senator SPECTER. How big is your company, Mr. Mason?

Mr. MASON. We are probably about $4 million this year.

Senator SPECTER. Do you sell many other products to Bell in competition with Western Electric?

Mr. MASON. Most of our products are in competition with other sectors of the general trade manufacturers. We have attempted to sell things to Bell to enhance their equipment which have certain deficiencies.

Because of the uniform tariffing program they have implemented recently, of which the committee may not be aware, we have been foreclosed from those markets.

Senator SPECTER. In your prepared testimony, you are critical of S. 898, saying that it will aggravate the competitive problems of general trade manufacturers. Can you be as specific as possible as to why you think S. 898 will do that?

Mr. MASON. If I might go through here a little bit, I think that question will answer itself.

Senator SPECTER. That is fine, Mr. Mason. Proceed in your own way.

Mr. MASON. Thank you.

Like many other general trade manufacturer firms, Valcom's products are manufactured primarily to specific needs within the telephone operating companies and of the Bell System in particular.

Small general trade manufacturers, in contrast to large firms like ITT or Automatic Electric, are a special category of telecommunications competitors.

THE SMALL AND MEDIUM-SIZED GTM INDUSTRY

As in Valcom's case, many small GTM's were inspired by the challenges and opportunities afforded under the post-Carterfone era of terminal equipment and telecommunications competition.

Unlike the more well-known equipment interconnect industry, the majority of small and medium GTM's compete directly with Western Electric and with each other for a portion of the apparatus and equipment business of the Bell System.

My company's products are purchased by the Bell operating companies to make up for feature deficiencies of Western Electric's basic product lines or to otherwise meet low volume or specialized customer service requirements.

GTM's also provide the Bell System with products that end users cannot yet provide for themselves and for which there is no significant end user market.

The small and medium sized GTM's can take considerable credit for introducing numerous technological innovations, new equipment services and features, and lower priced products.

I feel Valcom's telephone paging products, for example, personify the technological accomplishments and economic efficiencies which GTM's all over the country have made toward expanding and improving the quality of lost-cost telephone service to the Bell System subscribers.

GTM's endure enormous frustrations. We encounter a variety of unfair practices. We incur burdensome and wasteful product development and sales costs in our efforts to fill the Bell System's needs.

The typical small GTM is being run ragged by the current Bell System procurement structure. It spends unbelievable amounts of time and money chasing its tail in an endless "Catch 22" situation.

At great risk to my present and prospective business relationship with Bell, I would like to take this opportunity to point out one particular anticompetitive aspect of the Bell System's procurement structure—one which I feel will be aggravated in the deregulated environment of S. 898.

Here is where my cover reference to Mr. Archie McGill comes in. We have been trying to tell him that the public would buy our product if he would let the Bell operating companies offer it. My company's brief courtship in the Rose Garden of the Bell System sales ended when A.T. & T.'s business marketing department adopted a strategy of moving toward uniform nationwide product offering.

The strategy, as I see it, begins with A.T. & T.'s business marketing selecting a favorite product. It then issues a strong recommendation to the Bell System's operating companies to offer that product as an A.T. & T. system standard.

A.T. & T. then follows up with the recommendation with complete operating company support, including technical and marketing documentation, standardized service agreements, cost studies for State regulatory purposes, and complete tariff support, including recommended uniform rate levels to be filed in each local jurisdiction.

Senator **Specter**. Mr. Mason, we appreciate the problems you might have with your customer. We commend you for coming. I am sorry to interrupt you. We do have your full statement, and we shall review it.

I am advised that the buzzer is going to go off within about five minutes, and I will have to leave within about seven minutes after that.

I would like to just take the balance of your testimony and give you special thanks for the unique sensitivity of your situation and for coming here. I would express the committee's appreciation.

I would like to move now to Mr. Edwin A. Kilburn who is associate general counsel and director of litigation, International Telephone and Telegraph Corp.

Mr. Kilburn, we welcome you here. We would be pleased to hear from you now, noting that your full statement will be a part of the record. If you would summarize it, we would appreciate it.

STATEMENT OF EDWIN A. KILBURN, ASSOCIATE GENERAL COUNSEL AND DIRECTOR OF LITIGATION, INTERNATIONAL TELEPHONE & TELEGRAPH CORP., NEW YORK, N.Y.

Mr. **Kilburn**. Thank you very much, Mr. Chairman.

As you can see from the first paragraph of the prepared statement, I approach this problem from the standpoint of an antitrust lawyer.

I have been involved in antitrust litigation in the telephone industry, because I joined ITT in 1968.

I have talked about two particular problems—the equipment side and the transmission side—with S. 898.

Rather than to go back and try to repeat that, let me address a question which you asked one of the economists on vertical integration: Is it ever good? What is wrong with it in this industry?

I think the difference between a competitive firm—say, an RCA or a General Motors—operating and the question of whether they make their own picture tubes or their own transmissions is that if they make them and they do not do a good job of it, the price of their end product to the customer is going to be noncompetitive with someone who is doing a better job.

In the regulated context of rate base regulation, the incentives are all wrong. The numbers do not matter. However, suppose I offer a product to A.T. & T. ITT offers $100; the Western Electric price is $115. If they can find any way to justify paying the $115, the incentive is there; because they do not lose the profit Western Electric would make on the equipment. The $115 goes into the rate base on which they will then ask a regulatory agency to permit them to earn 8, 12, or 15 percent.

Senator SPECTER. Do you favor divestiture?

Mr. KILBURN. I think that is ultimately the cleanest and probably the most efficacious solution.

Senator SPECTER. Do you think there is any way to make it work out with fully separated affiliates?

Mr. KILBURN. I think you can go a long way toward getting a separate profit center concept introduced into the Bell System which is the way basically ITT operates. It would not be as good as divestiture, but I think there are a lot of improvements and a lot of ways you could do that in support of the FCC's first modest steps in phase two to try to introduce that kind of structure into the system.

Senator SPECTER. Do you think that there is anything that can be done to improve S. 898 to make it acceptable from your point of view?

Mr. KILBURN. There are a lot of things that could make it a better bill. It is right now so large and so cumbersome that I see it as a litigator's dream.

Senator SPECTER. Outside counsel's dream?

Mr. KILBURN. I am an inside counsel. It would be a great source of order input for me also.

Senator SPECTER. It would be a dream for inside counsel?

Mr. KILBURN. For both.

It will be a nightmare in terms of costs.

Senator SPECTER. You are not compensated on a time basis are you?

Mr. KILBURN. No; but it is nice to have something to do when you come into work in the morning. [Laughter.]

Senator SPECTER. Would a quota system for equipment purchases help?

Mr. KILBURN. It certainly would. We would definitely support the proposal in that respect.

Senator SPECTER. I am sorry to abbreviate your testimony, Mr. Kilburn, but I do want to turn to Mr. Thompson for a few minutes.

This panel is being cut short, and I am sorry that that has happened.

When I go down, there is going to be a series of votes. I do not think it realistic to come back.

You gentlemen can stay and continue the testimony, which we do when a Senator cannot be present here. Your supplemental testimony—and this would apply to you, Mr. Mason, as well as to you, Mr. Kilburn, and you, Mr. Thompson—will be a part of the record and will be available for all the purposes of the record testimony. You will have an opportunity to fulfill on that.

Mr. Thompson, under these circumstances, I welcome you especially.

STATEMENT OF THOMAS L. THOMPSON, DIRECTOR, INDEPENDENT DATA COMMUNICATIONS MANUFACTURERS ASSOCIATION, INC., WASHINGTON, D.C.

Mr. **Thompson**. Thank you.

S. 898 would replace regulation of large segments of A.T. & T. with deregulation. The deregulation would be allowed if A.T. & T. sets up what is called a "fully separate affiliate."

Senator **Specter**. Mr. Thompson, I did not say that you are a director of Independent Data Communications Manufacturers Association.

I think that should be said, and I do so now.

Mr. **Thompson**. Thank you.

The "fully separate affiliate" prescribed by S. 898 and unseparated A.T. & T. affiliates under the provisions of that bill would be anything but separate. The bill is riddled with loopholes and unnecessary exceptions to the separation requirements.

As a result, we feel that, from a manufacturers' perspective that the part of A.T. & T. that would be operating now on a deregulated basis would have all the advantages of deregulation while retaining all the competitive advantages that it will reap through its association with A.T. & T.—the subsidies, the tying effects, and the other advantages that will flow from A.T. & T. as a monopoly service provider to the separated affiliate.

Senator **Specter**. You are opposed to S. 898.

Mr. **Thompson**. Absolutely.

Senator **Specter**. If it is to be adopted, do you think that you favor divestiture?

Mr. **Thompson**. Our first preference certainly would be divestiture. Again, speaking from a manufacturer's perspective, we feel that at least parts of Western Electric—those that manufacture the terminal equipment that is going to be deregulated, as well as the support activities of Bell Labs for that activity—should be divested.

Senator **Specter**. Would you support a quota system for equipment purchases?

Mr. **Thompson**. I believe that would be better than what we have today, at least on an interim basis.

Senator **Specter**. How would you structure such a quota system?

Mr. **Thompson**. I am not sure that I can answer that.

Proposals have been to require that one-third or one-half of the Bell operating companies' procurements be from suppliers other than Western Electric.

As other witnesses have testified, the FCC has been considering this for some period of time. Our association has participated in those proceedings. We plan to participate in the proceedings that have just been reinitiated.

Senator **Specter**. You heard Mr. Thorsen's testimony and the New York experience where he said that he thought they could avoid cross-subsidization. Do you think that it might be possible to have a check to see to it that Bell, as a purchaser of a fully separated affiliate—Western—bought only where Western was competitive as opposed to the purchaser's company?

Mr. THOMPSON. I would say certainly not under the provisions of the bill. There is no provision in the bill for any outside procurement activity by either the fully separated affiliate or the Bell operating companies that would remain under regulation.

That is one of the major flaws in the bill, we feel. It does not address the restrictive procurement practices of the Bell System.

Senator SPECTER. Do you think it realistic to structure with fully separated affiliates some provisions for standards as to when they cannot purchase from their fully separated affiliate?

Mr. THOMPSON. I think if they use truly competitive bidding procedures, advertised bidding to published specifications, multiple sources of supply, and so forth, that would certainly open up their procurement—much more so than it is today.

Senator SPECTER. Even with a fully separated affiliate, what is to stop Western from having a low bid and then greater profits for the parent?

Mr. THOMPSON. As long as they are under the same corporate umbrella, there would certainly be incentives to operate that way; yes, sir.

Senator SPECTER. I am sorry that I must depart now. When the five bells come, that means there are 7½ minutes before this vote is tallied.

I am going to turn the chair over to counsel.

It is our practice for the committee to receive testimony with counsel in the chair and presiding.

Thank you very much for coming, gentlemen.

Ms. TIFFANY [acting chairman]. Mr. Thompson, would you like to continue with the summary of your statement?

Mr. THOMPSON. Yes; I would.

I had the honor of testifying before this committee in June. At that time, I talked about anticompetitive practices and the state of regulation.

Today I would like to alert you to our concern over proposals to deregulate substantial segments of A.T. & T.'s activities and to substitute for regulation a scheme of structural separation.

The only structural plan that will eliminate abuses, promote competition, and lessen the need for regulation in the terminal equipment market is the divestiture of those portions of Bell Labs and Western Electric that develop and manufacture terminal equipment.

Structural separation short of divestiture will not alter A.T. & T.'s incentives to abuse its monopoly position.

S. 898 will not even curb the opportunities to follow through on those incentives.

While S. 898 purports to require a fully separated affiliate, or FSA, A.T & T.'s unregulated affiliate will not be fully separated from A.T. & T.'s regulated operations. In fact, the separation provisions of the bill are riddled with unnecessary exceptions.

IDCMA members are most concerned by the need for full separation of research, development, and manufacturing activities. The proponents of S. 898 claim the bill requires the FSA to perform these functions; but the facts are quite different.

The bill contemplates a lengthy transition period, during which unseparated elements of A.T. & T. may perform a wide variety of activities for the FSA and then it fashions permanent exceptions of major significance.

The 6-year transition to separation is clearly longer than necessary. It ignores the fact that product development cycles in our high techology industry may be only 2 or 3 years. It also fails to recognize the relative ease of implementing separation requirements for certain product lines, such as data communications equipment.

Ms. TIFFANY. Mr. Thompson, how long a transition period would you believe is necessary?

Mr. THOMPSON. As soon as possible. We feel the FCC should have the authority to adjust that as conditions warrant.

Certainly no longer than 3 years. It certainly makes no sense to grant deregulation in 2 years when the transition period is 6 years.

If separation is to replace regulation, then it must be in place and tested before deregulation.

More troublesome still is the fact that the FSA need never be fully separated for research and manufacturing. It can draw forever on unseparated parts of Bell Labs and Western Electric for development and manufacturing of components and subassemblies.

Components and subassemblies include all the parts of an item of equipment, including all of the intelligence of the device. To an ever increasing extent the component is the product.

As companies that develop and manufacture customer premises equipment and who invest substantial effort in the development of components, IDCMA's members are gravely concerned by the loopholes in the bill's requirements for structural separation of manufacturing and associated R. & D.

Another inconsistency between the concept of full separation and the actual provisions of S. 898 is that the bill expressly authorizes joint ventures and partnerships between A.T. & T. and the fully separated affiliate.

This open ended provision seems to encourage the circumvention of the separation rules and will most certainly assure the continuation of cross-subsidies, discriminatory information flows, and tying effects.

The bill also contains other significant flaws in the separation scheme, such as joint advertising, joint use of property, common financing, and transfer of employees back and forth across the separation line.

These many exceptions to the separation rules show conclusively that S. 898 does not provide full separation, particularly as pertains to A.T. & T.'s and Western Electric's CPE manufacturing activities.

Ms. TIFFANY. Mr. Thompson, would you then feel that even if there were a system developed to detect financial cross-subsidization that the transfer of employees and information might result in cross-subsidization that would not be detected?

Mr. THOMPSON. Absolutely.

Ms. TIFFANY. Can you suggest any solutions to that problem?

Mr. THOMPSON. Yes—forbid the transfer or rotation of employees between the unregulated and regulated sides of the Bell System.

Ms. **Tiffany**. What about information transfers?

Mr. **Thompson**. I think the bill does address information transfers and does require release of information when it goes from the regulated side to the separated affiliate. However, the timing is not the same for release of the information to nonaffiliates as it is to the affiliate. It has to go through a clearance process—through three secretaries.

Its release to nonaffiliates could be delayed. In fact, it could be prevented altogether.

Ms. **Tiffany**. What about information transfers going in the other direction from the affiliate to the dominant regulated carrier? Do you think that there are problems with that?

Mr. **Thompson**. That is not our primary concern. Our main concern is that, because Bell owns the network that everyone must use—our equipment has to connect to that network—changes in that network can affect the ability of our equipment to operate. Therefore, the information we are concerned about is information regarding changes that Bell is planning to make or has made in the network, because it affects the ability of our equipment to operate.

Ms. **Tiffany**. Mr. Kilburn, do you agree with that concern about the information flow?

Mr. **Kilburn**. It is definitely a concern. That is one of the big problems that we have in manufacturing equipment—to get the interface information—because Bell will not consider your equipment unless it, of course, works with the system.

Generally, the operation under the consent decree has been that Western is in manufacture of its equipment before you get the necessary information to make the competitive product. You are always starting off 2 to 3 years behind.

Ms. **Tiffany**. Do you also agree that your concerns are not as great with information going from the affiliate to the dominant regulated carrier?

Mr. **Kilburn**. I would say not, but I have not really thought about that question, frankly.

Ms. **Tiffany**. Do you have any further comments, Mr. Thompson?

Mr. **Thompson**. Yes; I do.

The lack of adequate separation will, contrary to the stated goals of S. 898, jeopardize competition and increase the need for regulation.

Also, though the bill's stated goal is to increase competition, it does not even address A.T. & T.'s own restrictive procurement practices.

If I could leave just one additional thought.

The Commerce Committee has agreed to protect newspapers, cable television operators, and the alarm industry against competition from A.T. & T. If the FSA were truly fully separated, such special protection would not have been necessary.

We are not asking that A.T. & T. be excluded from the CPE segment of the market. We are urging this committee to formulate amendments that assure fair competition in all telecommunications markets.

We feel that divestiture provides the best solution. However, if separation of A.T. & T.'s regulated and unregulated activities is to be the approach, then the line separating those activities must be a solid line and not a dotted one.

Thank you.

Ms. TIFFANY. Thank you, Mr. Thompson.

Mr. Kilburn, Senator Specter asked you about the benefits of a quota system. I was wondering if you would elaborate a little more on that.

Mr. KILBURN. Mr. Brophy in his testimony before the Commerce Committee set out a kind of staged series of steps to get to the idea of 50 percent in outside procurement.

The advantage of a quota system is that it does something for sure, whereas setting up requirements of fair and competitive and dealing with open procurement practices and things like that may or may not actually cause a change in behavior.

If you have a set of targets that have to be met year by year and have to justify the failure to make it, then you have turned the incentives in the other direction. Instead of looking for excuses not to buy, you are looking for reasons to buy equipment from outside manufacturers because there is a mandate that says you must.

It is a very simple and direct way of getting to the problem. It is more complicated than divestiture, obviously.

I think that is the merit definitely from a theoretical and practical standpoint of a clean break. You are not as concerned. You eliminate the motivation for dealing with a particular company. There is no reason to buy its products if the products do not fit your needs or are not priced the way you want them.

The quota system goes a long way toward the same thing.

Ms. TIFFANY. Mr. Mason, would you agree that the quota system would assist you as a small manufacturer?

Mr. MASON. Yes; deregulation eventually is obviously coming in total and probably in the long run.

Small manufacturers have to look at the short run. We foresee that the only thing that can keep a small manufacturer going is for the Bell System to be looking outside. The only thing that will cause them to look outside is a requirement to buy outside, in terms of a quota.

We would hope that that quota would be spread evenly across product areas, rather than just being lumped into toilet paper and stationary and paper clips.

Ms. TIFFANY. Mr. Kilburn, in your written testimony, you comment on section 222's provision for requiring equitable treatment in charges for exchange access and the requirement that such charges be uniform for comparable types of exchange access sufficient to guarantee equal treatment of ITT's long distance service and the competing service that may be offered by A.T. & T.'s own separate affiliate.

Do you think that that equitable treatment requirement is adequate or would you recommend some amendment to that lanugage?

Mr. KILBURN. The problem I was addressing in this interconnection area is that it does not call for equal treatment or equal access. It talks about giving access upon reasonable request to be nonpreferential and nondiscriminatory. Those words sound very good, but the problem is that when you ask for a particular form of interconnection on particular terms as for a particular kind of service—super-groups and whatever—and you are refused, what is your remedy. Your remedy is to go back to the FCC and say: We asked for this interconnection, and we did not get it. Make them give it to us.

We just had an experience in that respect this past week with a similar request for interconnection. It happened in the international area where we bring traffic into the United States through one of a number of gateways or gateway cities and then have to turn it over to Western Union to be delivered into the hinterland.

We started a proceeding back in 1972 asking to be authorized to provide service in more than the two gateways that Western Union was willing to give us interconnection arrangements.

Four years later the FCC said that it would be a good idea for all of the international carriers to offer service at each of the five gateway cities. We went to Western Union and asked for interconnection, and we were refused. We complained to the FCC.

In 1980, the FCC said: Yes; Western Union should have given us interconnection, and that it was a violation of the communications act for them to refuse to.

Last week, they decided that we were wrong. It was not discriminatory to give TRT interconnection in Miami but to refuse it to us for one of the five gateway cities we had requested.

There we are; 9 years of litigation, and we still do not have the interconnection.

That is what S. 898 sets up—the same kind of litigation potential for asking for the service and being refused or being offered something inferior or something less than what you asked for and being given the option of litigating or accepting what it is that you are offered.

Ms. TIFFANY. When A.T. & T. was asked a similar question at a prior hearing, they commented upon the physical difficulties of providing equal access. In some cases, it is physically impossible.

Even assuming it is physically impossible, I imagine in many cases it would be extremely expensive. Would you comment as to your views on the physical capabilities and also on who should bear the expenses?

Mr. KILBURN. I am afraid you have the wrong witness to talk about the techniques of the operations. I am not expert in that area.

I think if you require equal access and put the burden on the carrier who is saying that he cannot do it because of cost or if you say it is equal access as between your own affiliate and the outside competitor—if he cannot give it to you, then he cannot give it to them—then I think you change again the incentive and the motivation.

If they cannot offer the service unless they can offer equal interconnections, then I will bet that they will find ways to offer equal interconnections. It will not turn out to be as costly as predicted.

Ms. TIFFANY. Where there is a will there is a way; right?

Mr. KILBURN. That is what I would say, yes.

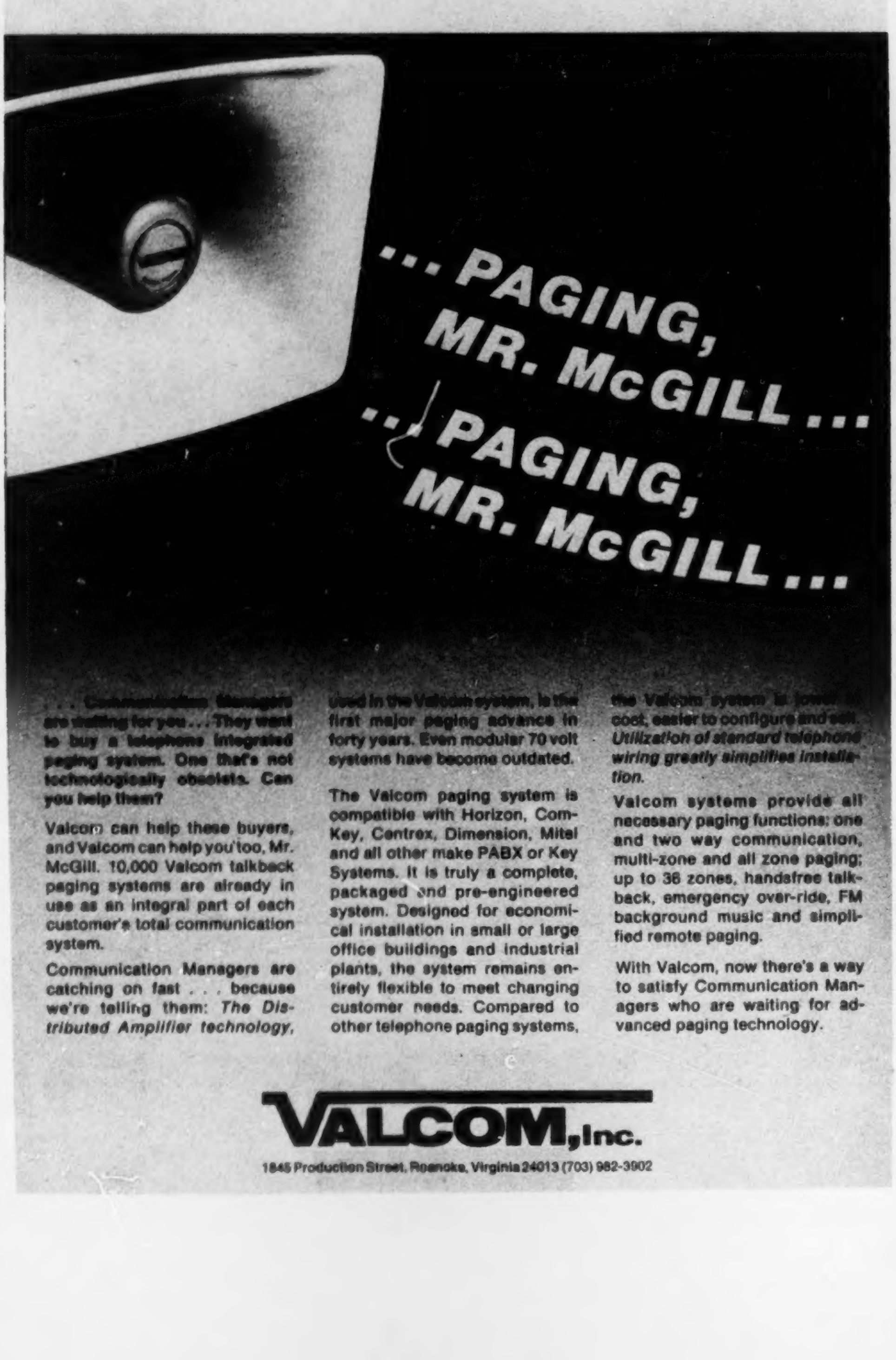
Ms. TIFFANY. Thank you, gentlemen. I have no further questions. This hearing is now recessed.

[Whereupon, at 3:30 p.m., the hearing recessed, to reconvene subject to call of the Chair.]

[Prepared statements follow:]

Prepared Statement of John Mason

President, Valcom, Inc.
Roanoke, Virginia



. . . Communication Managers are waiting for you . . . They want to buy a telephone integrated paging system. One that's not technologically obsolete. Can you help them?

Valcom can help these buyers, and Valcom can help you too, Mr. McGill. 10,000 Valcom talkback paging systems are already in use as an integral part of each customer's total communication system.

Communication Managers are catching on fast . . . because we're telling them: *The Distributed Amplifier technology,* used in the Valcom system, is the first major paging advance in forty years. Even modular 70 volt systems have become outdated.

The Valcom paging system is compatible with Horizon, Com-Key, Centrex, Dimension, Mitel and all other make PABX or Key Systems. It is truly a complete, packaged and pre-engineered system. Designed for economical installation in small or large office buildings and industrial plants, the system remains entirely flexible to meet changing customer needs. Compared to other telephone paging systems, the Valcom system is lower in cost, easier to configure and sell. *Utilization of standard telephone wiring greatly simplifies installation.*

Valcom systems provide all necessary paging functions: one and two way communication, multi-zone and all zone paging; up to 36 zones, handsfree talkback, emergency over-ride, FM background music and simplified remote paging.

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VALCOM, Inc.

1845 Production Street, Roanoke, Virginia 24013 (703) 982-3902

I AM JOHN MASON, PRESIDENT OF VALCOM, INC. OF ROANOKE, VIRGINIA. AS THE COVER PAGE OF MY TESTIMONY SUGGESTS, FOR THE PAST SEVERAL MONTHS MY COMPANY HAS BEEN "...PAGING MR. MCGILL." THAT'S ARCHIE MCGILL, OF COURSE, AT&T'S VICE PRESIDENT OF BUSINESS MARKETING. THE PURPOSE OF MY TESTIMONY IS TO URGE THIS COMMITTEE TO CONSIDER AFFIRMATIVE BELL SYSTEM PROCUREMENT POLICIES TO PROTECT THE SMALL AND MEDIUM GTM SUPPLIER FROM CERTAIN ANTICOMPETITIVE EFFECTS OF SENATE BILL S-898.

IN A FEW MOMENTS I HOPE YOU WILL UNDERSTAND WHY I HAVE BEEN TRYING TO GET MR. MCGILL'S ATTENTION.

VALCOM IS A SMALL MANUFACTURER WHICH HAS DEVELOPED A FEW GOOD "NICHE" PRODUCTS FOR THE BUSINESS TELECOMMUNICATIONS MARKET. LIKE MANY OTHER GTM FIRMS, VALCOM'S TELECOMMUNICATIONS PRODUCTS ARE MANUFACTURED PRIMARILY TO FILL SPECIFIC NEEDS WITHIN THE TELEPHONE OPERATING COMPANY MARKETS, AND OF THE BELL SYSTEM IN PARTICULAR.

SMALL GTM'S, IN CONTRAST TO LARGE FIRMS LIKE ITT, OR AUTOMATIC ELECTRIC, ARE A SPECIAL CATEGORY OF TELECOMMUNICATIONS COMPETITOR. AS IN VALCOM'S CASE, MANY SMALL GTM'S WERE INSPIRED BY THE CHALLENGES AND OPPORTUNITIES AFFORDED UNDER THE POST-CARTERFONE ERA OF TERMINAL EQUIPMENT AND TELECOMMUNICATIONS COMPETITION. BUT UNLIKE THE MORE FAMILIAR VOICE TERMINAL EQUIPMENT INTERCONNECT INDUSTRY WHICH COMPETES DIRECTLY WITH THE TELEPHONE OPERATING COMPANIES FOR END USER EQUIPMENT MARKETS, THE MAJORITY OF THE SMALL AND MEDIUM GTM'S COMPETE DIRECTLY WITH WESTERN ELECTRIC AND WITH EACH OTHER FOR A PORTION OF THE APPARATUS AND EQUIPMENT BUSINESS OF THE BELL SYSTEM.

Some GTM products are purchased as economical replacement components for components originally supplied by Western Electric. In the case of my company's products, they are purchased by the Bell operating company to make up for feature deficiencies of Western Electric's basic product lines, or to otherwise meet low volume or specialized customer service requirements. GTM's also provide the Bell System with products that end user customers cannot yet provide for themselves, and for which there is no significant end user market. These include, for example, transmission devices, line termination facilities, and central office devices used by the Bell System companies in virtually every aspect of telephone service.

The small and medium sized GTM's can take considerable credit for introducing numerous technological innovations, new equipment services and features, and lower priced products. I feel Valcom's telephone paging products, for example, personify the technological accomplishments and economic efficiencies which small GTM's all over the country have made toward expanding and improving the quality of low cost telephone service to Bell System subscribers.

Perhaps not known by members of this committee, GTM's endure enormous frustrations; we encounter a variety of unfair practices; and we incur burdensome and wasteful product development and sales costs in our efforts to fill the Bell System's needs. It goes without saying that we usually do not get Bell's business after all this grief. Expressed differently, the typical small GTM is being run ragged by the current Bell System procurement structure, and spends unbelievable amounts of time and money chasing its tail in endless "Catch 22" situations.

THE PROBLEMS OF ENDLESS DELAYS, OF DEAD END OR STONE WALL ENCOUNTERS, OF UNTIMELY RESPONSES TO TECHNICAL INFORMATION REQUESTS FOR MORE DETAIL IN ORDER TO BRING PRODUCTS WITHIN THE TECHNICAL SPECIFICATIONS OF THE BELL SYSTEM, OF SUDDEN AND UNEXPECTED DECISIONS WITHIN OPERATING COMPANIES TO DISCONTINUE THE HOST SYSTEM OFFERING WHICH USES A GTM SPECIAL PRODUCT, OR DECISIONS BY WESTERN ELECTRIC TO INTRODUCE, UNEXPECTEDLY, THE SAME OR VERY SIMILAR PRODUCT THAT GTM'S HAVE BEEN SUPPLYING TO THE BELL SYSTEM FOR YEARS, ARE ALL FAMILIAR EXPERIENCES. MANY OF THESE STORIES HAVE RECEIVED CONSIDERABLE PUBLIC ATTENTION IN THE F.C.C.'S DOCKET 19129 PROCEEDING, AND ALSO IN RECENT TESTIMONY IN THE *U.S.* VS. *AT&T* ANTITRUST CASE. BUT FOR THE MOST PART THERE EXISTS A GREAT AND UNDERSTANDABLE RELUCTANCE ON THE PART OF GTM'S LIKE ME TO CONVEY PUBLICLY THE KINDS OF CURRENT PROBLEMS AND BARRIERS WHICH WE FACE DAY-TO-DAY IN OUR PRESENT EFFORTS TO MAINTAIN, LET ALONE EXPAND, OUR BUSINESS OPPORTUNITIES WITHIN THE BELL SYSTEM.

AT GREAT RISK TO MY PRESENT AND PROSPECTIVE BUSINESS RELATIONSHIPS WITH BELL, I WOULD LIKE TO TAKE THIS OPPORTUNITY TO POINT OUT ONE PARTICULAR ANTICOMPETITIVE ASPECT OF THE BELL SYSTEM'S PROCUREMENT STRUCTURE--ONE WHICH I FEEL WILL BE AGGRAVATED IN THE DEREGULATED ENVIRONMENT OF SENATE BILL S-898.

CENTRALIZED PROCUREMENT RESPONSIBILITY AND AT&T'S SYSTEMWIDE PRODUCT STANDARDIZATION:

HERE IS WHERE MY REFERENCE TO ARCHIE MCGILL COMES IN. WE HAVE BEEN TRYING TO TELL HIM THAT THE PUBLIC *WOULD* BUY OUR PRODUCT, IF HE WOULD ONLY LET THE BELL OPERATING COMPANIES OFFER IT. MY COMPANY'S BRIEF COURTSHIP IN THE ROSE GARDEN OF BELL SYSTEM SALES ENDED WHEN AT&T'S BUSINESS MARKETING DEPARTMENT ADOPTED A STRATEGY OF MOVING TOWARD "STANDARDIZED" NATIONWIDE PRODUCT

OFFERINGS. THE STRATEGY, AS I SEE IT, BEGINS WITH AT&T'S BUSINESS MARKETING DEPARTMENT SELECTING A FAVORITE PRODUCT. IT THEN ISSUES A "STRONG" RECOMMENDATION LETTER TO THE BELL SYSTEM OPERATING COMPANIES TO OFFER THAT PRODUCT AS AN AT&T SYSTEM "STANDARD." AT&T THEN FOLLOWS UP THE RECOMMENDATION WITH COMPLETE OPERATING COMPANY SUPPORT, INCLUDING TECHNICAL AND MARKETING DOCUMENTATION, STANDARDIZED SERVICE AGREEMENTS, COST STUDIES FOR STATE REGULATORY PURPOSES, AND COMPLETE TARIFF SUPPORT, INCLUDING RECOMMENDED UNIFORM RATE LEVELS TO BE FILED IN EACH LOCAL JURISDICTION. NONE OF THESE SUPPORT SERVICES ARE PAID FOR, INCIDENTLY, BY THE OPERATING COMPANY DIRECTLY. NOR ARE THEY COVERED IN THE PRICE THE TELEPHONE COMPANY PAYS FOR THE "STANDARDIZED" PRODUCT.

UNDER THE PRESENT FULLY REGULATED REGIME, THIS BUSINESS MARKETING STRATEGY IS BEING IMPLEMENTED SUCCESSFULLY BY CAREFULLY ORCHESTRATED, SYSTEMWIDE TARIFF FILINGS.

IN THE UNREGULATED REGIME TO FOLLOW, WHETHER UNDER THE F.C.C.'S COMPUTER II STRUCTURE, OR UNDER THAT CONTEMPLATED BY S-898, BELL'S EQUIPMENT ENTITY APPEARS READY TO FOLLOW THIS SAME STRATEGY. THROUGH CENTRALIZED PURCHASING AND NATIONWIDE PRODUCT "STANDARDIZATION" SMALL GENERAL TRADES SUPPLIERS WITH LIMITED MANUFACTURING CAPACITIES WILL BE EXCLUDED AUTOMATICALLY FROM THE OPPORTUNITY TO PROVIDE ANY PORTION OF THE NEW ENTITY'S SYSTEMWIDE REQUIREMENTS. A CENTRALIZED PROCUREMENT STRUCTURE WILL FAVOR WESTERN ELECTRIC OR ITS COUNTERPART FOR DEREGULATED PRODUCT OFFERINGS, OR AT LEAST FAVOR THE HANDFUL OF VERY LARGE MEMBERS OF THE GENERAL TRADES INDUSTRY. THUS, SMALL COMPANIES LIKE MINE ARE DESTINED TO REMAIN SMALL AS WE VIE FOR THE REMAINING NON-BELL PORTION OF THE GTM EQUIPMENT MARKET. OR WORSE YET, TECHNOLOGICAL INNOVATION AND THE ECONOMIC BENEFITS

WHICH COMPETITION FROM FIRMS LIKE MINE HAVE CONTRIBUTED IN THE PAST DECADE WILL SUFFER AS SMALL GENERAL TRADES SUPPLIERS ARE FORCED OUT OF BUSINESS.

MY FORECAST OF DOOM IS BASED ON RECENT FIRST HAND EXPERIENCE. I FORMED VALCOM IN MAY, 1977, JUST A FEW MONTHS AFTER THE F.C.C. RELEASED ITS DECISION IN DOCKET 19129. IN FACT, I CAN HONESTLY TESTIFY THAT MY DECISION TO START A NEW COMPANY AND TO GO AFTER THE BELL SYSTEM MARKET FOR GENERAL TRADES PRODUCTS WAS MADE IN TOTAL RELIANCE ON THE F.C.C.'S PROMISE IN DOCKET 19129 TO ORDER AT&T TO ESTABLISH A PROCUREMENT STRUCTURE WHICH WILL ENSURE "AUTONOMY AND INDEPENDENCE" IN THE BELL OPERATING COMPANIES' DEALINGS WITH THE GTMS. OF COURSE, HINDSIGNT CONFIRMS THAT MY RELIANCE WAS MISPLACED.

AT THE OUTSET I HAD MY EYE ON A PARTICULAR "NICHE" OR DEFICIENCY IN WESTERN ELECTRIC'S PRODUCT LINE. THERE WAS AN OBVIOUS NEED AT THE TIME, AND ONE WHICH CONTINUES TO THIS DAY, FOR A TELEPHONE PAGING SYSTEM WHICH COULD EASILY AND EFFICIENTLY BE ADAPTED TO WESTERN ELECTRIC'S BASIC BUSINESS TELEPHONE PRODUCT LINE.

VALCOM IMMEDIATELY DEVELOPED A PAGING SYSTEM FOR THE BELL OPERATING COMPANY MARKET. OUR SYSTEM WAS DESIGNED FOR WESTERN ELECTRIC EQUIPMENT AND, MOST IMPORTANTLY, OPERATED WITH CONVENTIONAL, INPLACE TELEPHONE WIRING. THE COMPONENTS COMPRISING OUR SYSTEM REFLECTED STATE-OF-THE-ART TECHNOLOGY, ADAPTED TO AND MADE PRACTICAL BY VALCOM FOR TELEPHONE APPLICATIONS. I CAN PROUDLY SAY THAT THERE IS NO OTHER PRODUCT LIKE IT; AND NO OTHER PRODUCT THAT CAN BE INSTALLED WITH EXISTING BELL SYSTEM EQUIPMENT AT LESS COST.

IN 1978 OHIO BELL SELECTED VALCOM AS ITS PAGING EQUIPMENT SUPPLIER

FOR ALL PAGING SYSTEMS, INCLUDING THOSE TO BE SUPPLIED WITH WESTERN ELECTRIC'S COMKEY. IN 1979, AND AGAIN IN 1980, NEW ENGLAND TELEPHONE WROTE TO VALCOM STATING THAT IT HAD SELECTED VALCOM'S PAGING SYSTEMS TO BE OFFERED TO ITS CUSTOMERS. IN 1981 SOUTHERN BELL ALSO SELECTED AND TARIFFED VALCOM'S PAGING SYSTEM, WHILE SOUTH CENTRAL BELL AND C&P TELEPHONE COMPANY HAVE BEEN USING IT ON A SPECIAL ASSEMBLY BASIS.

NOTWITHSTANDING THE NEAR IMMEDIATE ACCEPTANCE OF OUR NEW PRODUCT BY SEVERAL BELL SYSTEM OPERATING COMPANIES (A VERY RARE SITUATION) WE HAVE RECENTLY LEARNED THAT VIRTUALLY NONE OF THESE COMPANIES WILL RENEW ORDERS, OR PLACE FIRM ORDERS FOR ADDITIONAL VALCOM PAGING PRODUCTS IN THE FUTURE. THE EXPLANATION--ARCHIE MCGILL'S BURINESS MARKETING GROUP HAS DECIDED THAT THE BELL SYSTEM SHALL "STANDARDIZE" ON ANOTHER VENDOR'S PAGING PRODUCT. FURTHER, IT IS BELIEVED THAT AT&T HAS "RECOMMENDED" THAT ALL OPERATING COMPANIES TARIFF THE "STANDARDIZED" PRODUCT WITHIN THEIR TERRITORIES FOR FUTURE CUSTOMER PAGING SERVICE REQUIREMENTS.

THERE CAN BE NO MEANINGFUL PURCHASING AUTONOMY AT THE LOCAL LEVEL IF AT&T IS PERMITTED TO CONTINUE ITS PRESENT PRODUCT "STANDARDIZATION" PRACTICES IN THE DEREGULATED MARKETPLACE.

IT WOULD SOUND LIKE SOUR GRAPES IF I WERE TO TESTIFY THAT OUR PRODUCT SHOULD HAVE BEEN SELECTED OVER THAT OF THE OTHER VENDOR AS THE AT&T "STANDARD". LET ME JUST SAY THAT, AS A SMALL GTM WE NEVER STOOD A FAIR CHANCE FOR BELL'S BUSINESS AS THE SYSTEM "STANDARD". THIS IS BECAUSE WE WERE NEVER GIVEN AN OPPORTUNITY TO PROVE WHETHER WE COULD HAVE SUPPLIED THE BELL SYSTEM'S TOTAL NATIONWIDE REQUIREMENTS FOR PAGING SYSTEM PRODUCTS. WHETHER WE LOST TO WESTERN ELECTRIC, OR TO ANOTHER BUT LARGER GTM SUPPLIER, THIS RECENT EXPERIENCE ACCURATELY AND REALISTICALLY

PORTENDS THE KIND OF UNFAIR DISADVANTAGE WHICH SMALL GTM'S WILL EXPERIENCE IF AT&T IS PERMITTED TO FOLLOW CENTRALIZED PURCHASING AND A STANDARDIZED PRODUCT STRATEGY,

TODAY WE ARE BEING REJECTED AT THE OPERATING COMPANY LEVELS BECAUSE AT&T HAS CHOSEN TO "STANDARDIZE" ITS TARIFF OFFERINGS ON A NATIONWIDE BASIS; TOMORROW WE WILL BE REJECTED BECAUSE THE NEW, DEREGULATED ENTITY WILL CHOOSE TO EXERCISE ITS ". . .INDEPENDENT, PRUDENT BUSINESS JUDGEMENT." (S-898, SECTION 228(A).) WHATEVER THE EXPLANATION, THERE IS NO PLACE IN A COMPETITIVE DEREGULATED ENVIRONMENT FOR EITHER LEGISLATION OR REGULATORY POLICIES WHICH CONDONE, LET ALONE PROMOTE, BELL PROCUREMENT STRATEGIES DESTINED TO FORECLOSE BOTH EXISTING AS WELL AS FUTURE BELL SYSTEM BUSINESS TO THE SMALL AND MEDIUM-SIZED GTM SUPPLIER.

IT IS APPARENT THAT A LEGISLATIVE SOLUTION IS NECESSARY TO OPEN, PRESERVE AND ENHANCE THE MARKET OPPORTUNITY AND PUBLIC BENEFITS WHICH WILL FLOW FROM CONTINUED AND EXPANDED GTM SALES TO THE BELL SYSTEM. TO MY KNOWLEDGE, THE PROBLEMS AND INTERESTS OF THE SMALL GTM'S HAVE NOT BEEN PRESENTED TO CONGRESS IN THE CONTEXT OF PREVIOUS EFFORTS OVER THE PAST 6 YEARS TO REWRITE THE COMMUNICATIONS ACT. (THE GTMS ARE NOT ORGANIZED, NOR REPRESENTED BY ANY NATIONAL TRADE OR INDUSTRY ASSOCIATION.) IT IS THEREFORE NOT SURPRISING THAT S-898 DOES NOT SPECIFICALLY REFERENCE THIS COMPETITIVE INDUSTRY SEGMENT.

IN MY VIEW, SATISFACTORY TELECOMMUNICATIONS LEGISLATION MUST, AS A MINIMUM, INCLUDE AN ACCOMMODATION FOR THE CONCERNS OF THE SMALL GTM'S LISTED IN THE APPENDIX ATTACHED TO THIS TESTIMONY. SENATE BILL S-898 WOULD BE MORE ATTRACTIVE TO VALCOM IF, AS A MINIMUM, THE ATTACHED PRINCIPLES WERE IN-

CORPORATED, AND IF THE LEGISLATIVE HISTORY OF S-898 EXPRESSLY ACKNOWLEDGED A CONGRESSIONAL INTENTION TO PROTECT AND PROMOTE AT&T PROCUREMENTS FROM THE GTM INDUSTRY IN THE INTEREST OF FOSTERING FAIR AND FULL COMPETITION. MANDATORY SMALL BUSINESS GTM PROCUREMENT QUOTAS SHOULD BE IMPOSED ON AT&T, AT LEAST DURING AN EXTENSIVE TRANSITION PERIOD.

TO THIS END I WISH TO THANK THE COMMITTEE FOR THE OPPORTUNITY TO PRESENT THIS TESTIMONY.

ENCLOSURE.

APPENDIX TO THE TESTIMONY OF JOHN MASON

1) Congress should find and declare that "further" and "increased" competition in the supply of telecommunications equipment means competition for both direct end user markets as well as for the GTM service and equipment markets of AT&T and those of its affiliates which sell to and/or service end users.

Rationale

Senate Bill S898 is completely silent as to the existance and importance of the GTM industry sector. This oversight should be corrected.

2) Either the Congress must mandate small business procurement quotas or other small business affirmative procurement obligations on AT&T and its affiliates, or the Commission must be given express authority to impose such requirements on and to otherwise monitor the small business procurement policies and practices of AT&T and its affiliates.

Rationale

Considering the enormous market share controlled by AT&T, and considering further the enormous size and complexity of AT&T's procurement organization and practices, affirmative small business procurement quotas offer the only feasible and effective scheme for ensuring the survival and growth of the small and medium sized members of the GTM industry. Further, such procurement quotas should apply uniformly to all product categories except network switching products. It must be emphasized that quotas should not become a device by which AT&T might curtail procurements from any GTM supplier but they should be regarded merely as a minimum procurement obligation.

Moreover, even under a scheme providing for small business quotas, centralized procurement of all but network switching products should be prohibited in favor of an autonomous, regionalized procurement structure. This will minimize instances of arbitrary and capricious product rejections by those with purchasing authority and ensure small GTM's multiple opportunities to sell their wares.

3) Provisions establishing a private cause of action in an appropriate federal forum for treble damages must be included in new legislation to ensure enforcement and a meaningful remedy to GTM's injured by any violations of provisions established to implement these principles.

Rationale

Currently there is no effective remedy for the small GTM supplier, short of alleging antitrust violations. A more direct and hopefully less costly form of remedial action is needed.

4) Finally, even before the passage of new legislation and throughout the transition period, Congress must require AT&T to disclose fully and on a timely basis all information pertaining to corporate planning, restructuring, and changes in organizations or policies which bear, directly or indirectly, on established and future relationships between existing and new Bell System entities and the general trade industry.

Rationale

The GTM industry cannot plan for the near future without knowledge of how AT&T plans to deal with GTM procurements in the deregulated environment. We should at least have the benefit of AT&T's latest thinking on this subject at all times until a new structure is firmly in place.

PREPARED STATEMENT OF EDWIN A. KILBURN

Thank you Mr. Chairman,

I am Associate General Counsel and Director of Litigation of ITT. It is a pleasure for me to be here to discuss monopolization and competition in the telephone industry as it is now and as it is likely to be if S. 898 becomes the law. I began my education in the telephone industry shortly after I joined ITT in 1968 when I became a member of the trial team in ITT's antitrust suit against GTE. In 1973 I became ITT's trial counsel in Phase II of the AT&T rate case. Following the FCC's decision in 1977 condemning AT&T's "buy-Western" bias in telephone equipment purchasing, I was the lead internal counsel on ITT's antitrust suit against AT&T. In sum, for the past 13 years I have been actively involved in ITT's long running efforts to introduce real competition into the U.S. telecommunications equipment market through application of existing antitrust laws in the face of the vertical affiliation of equipment manufacturers with their principal customers, the operating telephone companies, that characterizes 90% of the industry. Preeminently, this means the Bell Operating Companies (BOCs) and Western Electric.

A little over a month ago, Bill Forster, ITT's Product Group Manager for Telecommunications and Electronics, testified before this Committee on competition in the U.S. telephone equipment industry as it is today. The reality, he said, is that the Bell market is essentially closed to equipment manufacturers other than Western Electric. This past week ITT submitted a letter to Mr. Wunder, the head of NTIA, setting out in considerable detail ITT's position on S. 898. A copy of that letter was also sent to Mr. Baldrige, the Secretary of Commerce. I do not want to repeat either of those statements and would, therefore, respectfully ask permission to submit those letters as part of my testimony for the record of this Committee. You will find in the letter to Mr. Wunder a discussion of three recommendations which ITT can support.

When I joined ITT in 1968, AT&T enjoyed the most nearly perfect monopoly ever achieved by a private corporation in the United States. Consider the situation in telecommunications services and equipment: in each of its franchised territories, representing then as now, over 80% of the total U.S. market, the BOCs had a monopoly of telephone service; in long distance service AT&T Long Lines had nearly 100% of the market, about the only exception being the private systems of certain right-of-way companies, such as the railroad and the pipeline companies. Although large users had been authorized to establish private communications systems in the FCC's "Above 890" decision, AT&T's WATS and Telpak tariffs had successfully discouraged investment in such systems. On the equipment side, Western supplied virtually all of the telephone equipment purchased by the BOCs and Long Lines. In the GTE lawsuit ITT proved and the District Court found that Western's share of the Bell equipment market in 1968 and 1969 was 99.11%

and 99.17%, respectively. But what made the equipment monopoly perfect was that in the area of customer premise equipment the "foreign attachment" tariffs prevented all competition at the user level. The BOCs would not permit any equipment not furnished by them to be connected to the network, and the BOCs bought only from Western. Competition in long distance service was similarly prevented by AT&T's long standing policy of refusing to connect its local networks with any competing service.

The Bell System had enjoyed this monopoly situation for many years. The only determined attack on the System in recent years had been the first U.S. antitrust suit which was terminated by a Consent Decree in 1956. That Consent Decree confined AT&T to communications markets regulated by the FCC and Western to supplying equipment for the regulated markets, but in those markets AT&T continued as the supreme monopoly.

However, in 1968, the situation began to change. During that year, the FCC issued the now famous Carterfone decision. ITT had supported Mr. Carter and participated actively in the subsequent seven-year regulatory struggle that culminated with the FCC's establishing, over AT&T's determined opposition, an equipment certification program to permit direct connection of customer premises equipment to the network. This was the death knell of the foreign attachment tariff, which was based on the fiction that only Bell supplied equipment was fit to be connected to the Bell network. AT&T has always maintained that Western's preeminence as a supplier of equipment to the BOCs was based on the quality, performance and price of Western's equipment. However, in the competition established by FCC's certification program, Western, through the BOCs, has lost approximately 50% of the new installations to competing equipment suppliers which can now sell directly to the user. Were it not for Western's affiliation with the BOCs, which rely on Western equipment to compete with the interconnect suppliers, it is doubtful that Western would be able to retain even this diminished market share.

A little more than a year after the Carterfone decision, the FCC issued its Specialized Carrier decision, representing the first real crack in AT&T's monolithic control of long distance service. ITT has not been in the forefront of the regulatory struggle in that arena, yielding that position to MCI, but we did decide to make the investment to enter the market through U.S.T.S., and after a three-year legal fight with the Bell System our right to do so was confirmed by a federal appeals court.

With respect to the equipment market, ITT first challenged the in-house procurement policy of the General System. In addition to emulating the Bell System procurement practices, GTE was engaged in the early 1960's in a massive acquisition program of other independent telephone companies, thereby threatening to eliminate what little remained of the open market. In 1972 ITT won an extremely favorable judgment from the District Court in Hawaii. Although the divestiture portion was later reversed by the Ninth Circuit, the factual findings that corporate affiliation in the telephone industry leads to anticompetitive in-house purchasing policies and practices were not then, and never have been, successfully challenged. Moreover, the District Court condemned the Antitrust Division for its failure to move against the far more significant antitrust violator -- The Bell System. I cannot prove cause and effect, but it was not many months after Judge

Pence's decision in the GTE case that the Antitrust Division commenced the investigation of AT&T that led ultimately to its filing the complaint in U.S. V. AT&T in November 1974.

In 1973, at the insistence of Congress, the FCC finally, after eight years, took up the issue of the Western Electric relationship with the BOCs in what is known as Phase II of the AT&T Rate Case. Four years later it issued its decision finding as facts that there is a "buy-Western" bias in the Bell System and that Western owes its monopoly position in the BOC market not solely to the merits of its products, but to its affiliation with the BOCs and the existing structure of the AT&T System. Last week you were told by a witness for AT&T that the BOCs buy from Western because its prices are 16% lower than general trade prices. That statement is an average and obviously not true for all times and all products. Moreover, the witness did not tell you that the FCC found in Phase II that price surveys created by AT&T on which that and similiar statements in the past are based are worthless and lack any probative value. And the record developed in Phase II and in the U.S. antitrust case demonstrates that when the general trade has a price advantage over Western's comparable equipment, the BOCs continue to buy from Western.

For these reasons the Commission ordered AT&T to change its structure and policies in 1977 to put Western and the general trade manufacturers on an "arm's-length, fair and equal basis" with the BOCs. AT&T did not appeal that decision, but instead has refused to obey the Commission's order, claiming it is contrary to the public interest as AT&T views it. Only a few days ago the Commission agreed to put out for comment a modest first step to implement its order now over four years old.

What is the point of all this history? It is simply this. After losing nearly every battle on the regulatory and judicial front for 13 years in its efforts to preserve its monopoly positions in the telecommunications services and equipment markets, and with the final assault of the U.S. antitrust suit likely to reach a conclusion within a year, AT&T appears about to win the war instead on the legislative front through S. 898. For make no mistake about it, S. 898 is not a deregulation, pro-competition bill. Those are simply buzz words to hide the fact that only Bell is deregulated to compete on a virtually unrestricted basis in those areas where it has lost the fight for a closed monopoly market.

Where the issue is in doubt, S. 898 maintains the status quo in AT&T's favor. Let me illustrate. On the transmission side, AT&T retains both regulated MTS and managerial control over the FSA, which is free to build any facilities, offer any service, in competition with the other common carriers (OCCs). S. 898 does not even contain the simple requirement that the BOCs provide the same interconnection arrangements to the OCCs as are provided to Long Lines and the FSA. Nor is the FSA's right to offer a competitive service conditioned on a showing that the Bell System is providing equality of interconnection, which is the only truly effective way of forcing the Bell System to act properly. Instead, there are a lot of complicated provisions about the dominant carrier's obligation to provide nondiscriminatory and nonpreferential interconnection, but those provisions are qualified by such phrases as interconnection is required "upon reasonable request," or there is not to be discrimination "in an unreasonable or anticompetitive manner," or interconnection shall be ordered "after opportunity for hearing," etc. This means that AT&T will be free to follow its traditional interconnection policies of giving the OCC the connection it chooses to, or finds convenient, or none at all, leaving the OCC to its regulatory remedies, the same position it is in now. It took MCI many years of repetitive litigation to establish its right to interconnect on any terms with the local network. On the other hand, under S. 898 Long Lines and the FSA will automatically get the interconnection arrangements they require under AT&T's management. This is a travesty of deregulation or open competition. Only AT&T is deregulated. The OCCs remain regulated and we are supposed to compete with the unregulated monopoly.

On the equipment side, S. 898 may eliminate the threat to AT&T's in-house procurement policy represented by the Phase II decision and S. 898 may also provide a viable defense to a possible divestiture order against Western in the U.S. antitrust suit. First, the Van Deerlin bill in the last Congress (H.R. 3333) contained a provision that every affiliated organization of a dominant carrier shall "deal with every other affiliated organization of (a dominant carrier) in the same manner (according to the same arm's length arrangements) as such affiliated organization would deal with other companies and business organizations . . ." At AT&T's insistence, that provision was later stricken, although it did nothing more than provide a statutory basis for the regulatory order already issued by the FCC in Phase II in 1977. S. 898 not only contains no such provision, but worse, in Section 228 entitled "Amendments Relating to Research, Development and Manufacturing Activities of the American Telephone & Telegraph Company," there is a proviso that:

> "Nothing in this section shall prohibit or otherwise restrict any dominant-regulated carrier, affiliate or fully separated affiliate from exercising its independent, prudent business judgment in connection with business conducted with nonaffiliates."

The implication is that "independent, prudent business judgment" is the rule that Congress believes should apply in all circumstances and that Congress wants to be very sure that the specific provisions of Section 228 do not change that. Moreover, the FCC in subsection (e) is denied authority to establish any requirements relating to the "structure or organization of any affiliate of the dominant carrier which is not consistent with this section of the bill." This could be construed to eliminate the FCC's jurisdiction to require the structural changes initiated by its modest proposal of last week to carry out its 1977 Phase II order. That is the worst case. At best S. 898 leaves it open for AT&T to continue its traditional policy of in-house procurement with respect to the core network (switching and transmission) free of any legislative impediment and subject only to whatever the FCC manages to come up with by way of implementing its Phase II order. And in the customer premise equipment market S. 898 explicitly establishes a restructured Western as the supplier of equipment to the FSA.

In the case of the U.S. antitrust suit, others before me have pointed out that after Congress has definitively established the structure of the telephone industry, it will be a rare court to tamper with that structure on the basis of the Sherman Act. And this is true notwithstanding the reservation against antitrust immunity. Passage of this legislation would be the strongest possible public interest finding in the structure mandated or permitted by Congress. To the U.S., as a litigant in an antitrust suit, such a finding could prove to be an insurmountable obstacle to further restructuring of the industry. In any event, you can be sure that AT&T will take great solace in the proposed legislation and will strongly urge that positon to the District Court if it is found to have violated the antitrust laws and faces a divestiture order.

The antitrust suit represents a risk -- a very substantial risk -- to AT&T. That is why we have all witnessed the intense lobbying of recent weeks and months by AT&T, supported by its labor unions, to have this Administration drop the case and thereby confer de facto antitrust immunity on the largest corporate enterprise in the world. It has been reported that the Staff of an Administration Task Force has recommended that the case be dismissed. Even Senator Packwood was reported as believing that the pendency of the antitrust suit is an impediment to passage of S. 898 in the House of Representatives.

That would be the final triumph, a Silver Anniversary present -- AT&T's vertical structure to remain uninhibited with respect to the core network, and confirmed as to customer premise equipment, but without being restricted to regulated markets, the quid pro quo for permitting AT&T to retain Western at the time of the 1956 Consent Decree. And all in the name of deregulation and fair competition.

I know there are some people, even some members of this body, who take the position that we who oppose S. 898 are selfish competitors who are afraid to stand up to AT&T or Western in open competition. That is completely wrong. ITT is not afraid to compete. Though we are a small factor in every area, we have been competing for years against the stacked deck of vertical integration in the equipment market and Government created and sanctioned monopoly uncontrolled by effective regulation in the transmission markets. On the equipment side, only last year AT&T agreed to pay us $200 million rather than be put to the test of proving they did not use that stacked deck to foreclose ITT from selling a single line of transmission equipment to the BOCs. At the same time, ITT has been struggling for years to get rid of the stacked deck and to have all participants play the game according to Hoyle. Passage of S. 898 would put to naught all those efforts and the efforts of many others and consign the telephone industry forever to the total dominance of AT&T. That is why we oppose its passage.

Enclosures.

International Telephone and Telegraph Corporation

George F. Knapp
Vice President

67 Broad Street
New York, N.Y. 10004
Telephone (212) 797-8047

July 22, 1981

The Honorable Malcolm Baldrige
Secretary of Commerce
711 14th Street, N.W.
Washington, D.C. 20230

Dear Mr. Secretary:

I am addressing you as Chairman of the Task Force on Telecommunications Policy. As I understand it, the Task Force is considering options available to the Administration and the likely consequences for the telecommunications industry of the adoption of those options. The attached letter to Assistant Secretary of Commerce Wunder amplifies my recent discussion with him on telecommunications policy and details at some length the anticompetitive effects which would result from S. 898 as approved by the Senate Commerce Committee on July 16, 1981.

Passage of S. 898 or the dismissal of the Government's antitrust suit would effectively exempt the world's largest private monopoly from the antitrust laws, despite repeated court decisions holding AT&T guilty of antitrust law violations and AT&T's continuous filing of unlawful tariffs in the face of potential competition.

The analysis contained in the attached letter leads inevitably to the conclusion that S. 898 is a "New Bell Bill". The original "Bell Bill" in 1976 would have remonopolized through reregulation; this "New Bell Bill" would remonopolize in the name of "deregulation". The enactment of S. 898 would both decrease competition and increase the complexity and size of regulation. Briefly S. 898 would:

1. Decrease competition by foreclosing the multibillion dollar Bell System equipment market to non-Bell suppliers (it opens new markets to Bell and none to its competitors).

2. Decrease competition by permitting Bell to enter unregulated the terminal equipment market. Bell now holds a 90% share in its own operating areas and has a $10 billion investment which it acquired as the result of monopoly grant.

3. Decrease competition by permitting Bell to enter unregulated the specialized carrier transmission market without effective restraints against anticompetitive pricing and the joint use of facilities with Bell regulated companies, a decisive advantage over its competitors.

4. Increase regulation by requiring the FCC to determine effective competition in each geographic area or market for transmission services before deregulation applies.

5. Increase regulation by requiring the F.C.C. to police countless transactions between AT&T's unregulated affiliate and the regulated portions of the Bell System.

6. Continue without change the F.C.C.'s time-consuming, ineffective attempts to regulate AT&T's anticompetitive pricing of tariffed services. Moreover, a recent court case transfers virtually all anticompetitive pricing problems from the courts to the regulatory agencies, thus increasing the workload.

7. Establish a separate 100% AT&T owned corporation as a "fully separated affiliate" to protect the public. S. 898 then structures the management so that the affiliate can be operated as a fully integrated division of AT&T, in much the same manner as the Long Lines Division. It can truly be said of the proposed fully separated affiliate that "The Emperor Has No Clothes."

We believe that it is urgent that the Telecommunications Task Force develop alternative options to S. 898 either in the form of amendments, or preferably in a completely new bill, which would maximize competition, minimize regulation, and make really effective that regulation which remains essential.

I would appreciate the opportunity to meet with you to discuss the problems with regulation and competition in the telecommunications industry in a search for better solutions than those so far proposed.

Sincerely yours,

George F.

GFK/ls
Attachment

International Telephone and Telegraph Corporation

George F. Knapp
Vice President

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July 22, 1981

Mr. Bernard Wunder
Assistant Secretary of Commerce
National Telecommunications and Information Administration
1800 G Street, N.W.
Washington, D.C. 20504

Dear Mr. Wunder:

I appreciated the opportunity to discuss with you some of the problems I see in the Government's current attempts to introduce and promote competition in the telecommunications industry while proceeding with deregulation.

In this connection I have read with interest the memorandum from the Counsellor to the President, Mr. Edwin Meese III to the Secretary of Commerce, dated May 28, 1981, in which he requested the Secretary to establish the Task Force on Telecommunications Policy. In this memorandum Mr. Meese stated that the task force "mission would be to ascertain, and advise the President as to the present state of the telecommunications industry and the feasibility of actions to deregulate the industry and make it more efficient." Mr. Meese expressed the hope that "the task force can quickly develop a report to the President which would include options available to the Administration and the likely consequences for the telecommunications industry of the adoption of various options."

If I have read the statements of the Secretaries of Commerce and Defense (and the attendant publicity) correctly, two options have so far been considered:

1. Support passage of S. 898 (at least in principle and perhaps with amendments giving more regulatory authority to the Federal Communications Commission).
2. Drop the Department of Justice antitrust suit against AT&T (presumably this also includes the option of prompt settlement of the suit on terms agreeable to AT&T).

It is my considered view that the adoption of either of these options will increase both the opportunities for and the use of anti-competitive practices by AT&T resulting in both an increased regulatory workload and a reduction in competition. Despite this view, widely shared by those (both customers and competitors) who have to deal with the Bell monopoly problem on a daily basis, it is quite clear that the strong efforts to portray S. 898 as pro-competitive have been highly effective. For example, the Secretary of Commerce in his statement to the Senate Commerce Committee on June 11, 1981, strongly urged Congress "to act to facilitate greater competition in telecommunications by promptly enacting regulatory reform legislation patterned after S. 898."

S. 898 is long and complicated (needlessly so) but when you sort it out, its clear purpose is to enhance Bell's monopoly position at the expense of the relatively minor competition it now endures. In 1976, AT&T caused to be introduced in the Congress a bill to remonopolize the telecommunications industry by regulation. This legislation, co-sponsored by nearly two hundred legislators, and euphemistically called the "Consumer Communications Reform Act of 1976," came to be known as the Bell Bill. Now we have a new Bell Bill. But this time the Bell Bill, according to AT&T, promotes "full and fair competition". In our view, AT&T, having failed to persuade Congress to "remonopolize through regulation" now wants to "remonopolize through deregulation" capitalizing on the popular buzz words competition and deregulation.

S. 898 and Competition in the Market Place

As head of the NTIA, the Executive Branch's principal telecommunications policy agency, you are in a unique position to present the "Task Force on Telecommunication Policy" and others in the Administration interested in the AT&T monopoly problem a clear analysis of S.898 showing what it does and does not do for competition. My own analysis follows:

1. New markets opened to competitors of Bell System by S.898 - None. After decades of refusal to interconnect customer-owned terminal equipment on clearly specious grounds, the Bell System was forced, in a series of cases commencing with a filing of the Carterfone suit filed on November 29, 1965 and ending with Court of Appeals action in February, 1977, to interconnect terminal equipment meeting reasonable standards. (S.898 does not add to or detract from the actions by the Courts and the FCC.) The Bell System now grudgingly interconnects specialized carriers as a result of a series of Court and FCC actions commencing with a Section 214 permit applied for by MCI in 1963 through the Execunet court decision in 1977. However, the terms and conditions of interconnection remain subject to arbitrary determination by AT&T despite the FCC's ineffective regulatory efforts. (This problem will continue under S. 898.)

2. New markets opened to Bell System by S.898 - All markets from which Bell was previously excluded, except "cable service, mass media service, or mass media product" in Bell operating company markets, are opened to the Bell System by S.898. Bell may also provide the cable and mass media services in areas not served by Bell operating companies. In addition the alarm industry has been protected.

3. Existing markets foreclosed to Bell System by S.898 - None.

4. Existing markets foreclosed to competitors of Bell System by S.898 - Bell core network equipment market. AT&T claims this is an open market at present but takes every action to prevent the Bell operating companies from buying outside the system except in small quantities for limited periods of time.

   FCC and a few state regulatory agencies have made occasional efforts to force the market open, but without significant effect. During proceedings which have now lasted sixteen years, the FCC has ordered the Bell operating companies to deal with the general trade on a "fair and equal" basis and to deal with Western Electric on an "arm's-length basis." This order (Docket 19129)has been flaunted by AT&T now for more than four years with AT&T arguing that such requirements are equivalent to divestiture of Western Electric and, therefore, not in the public interest. S.898 does nothing to support the FCC's order and could be construed to permit (Sec. 228(a)) AT&T to foreclose entirely this multi-billion dollar market to competition by simply exercising its "independent, prudent business judgment."

5. Existing markets in which S. 898 enhances position of Bell System's competitors. - None. Bell's competitors are not even assured of timely and nondiscriminatory access to either the BOC's local networks or to Long Lines facilities. All interconnection rights of competitors remain subject to FCC regulation to enforce, while the FSA and Long Lines will automatically get the interconnection arrangements they desire under AT&T's management.

6. Existing markets in which S. 898 enhances position of Bell System - All equipment sales and telecommunications services for which regulatory restraints are removed from Bell System by S.898. S.898 permits the Bell System to immediately commence sales of terminal equipment by the Bell System "fully separated affiliate" in all geographical areas and markets in the country whether or not there is effective competition. Within 18 months the Bell System terminal equipment now owned by the Bell System operating companies and totalling some $10 billion will be transferred to the FSA. The Bell System now owns the terminal equipment in approximately 91 percent of the markets serviced by Bell operating companies. The only restraint on Bell's ability to take over 100 percent of this market is the requirement that it may not sell below average variable cost (Northeastern Telephone Company v. AT&T Co. decided May 27, 1981).

   The "fully separated affiliate" is also permitted to provide telecommunications transmission and switching services in any geographic area or market where the FCC finds effective competition. Again, the only restraint on the Bell System, which now controls about 99 percent of the telecommunications transmission market in the Bell Operating company areas, is that they may not predatorily price below average variable cost.

7. Existing markets in which competitive status quo is maintained by S.898 - S.898 continues for the time being (Sec. 203(3)) what little regulation of interexchange telecommunications carriers and services now exists until a finding of effective competition is made.

   It is contemplated that the FCC will classify and reclassify on a continuing basis carriers regulated or unregulated in each particular geographic area or market. In addition it must continue to exercise authority over pricing (at least in theory) in the geographic or market areas which continue to be regulated. (No pricing guidelines are furnished by S.898.). The Commission has never had control over AT&T pricing and there is no basis to expect this to change in the future.

Sec. 201 of S. 898 ostensibly requires that regulation shall be minimal, However, it seems clear that S.898 adds to both the size and complexity of FCC's regulatory activities - a load which the FCC has demonstrated it has neither the staff nor the expertise to handle.

AT&T's Domination of the Market Place

The clear thrust of S.898 promoting AT&T's ability to compete with its so far insignificant competitors would not seem to be based on any lack of resources of the Bell System. A comparison of AT&T and the top 10 Fortune 500 Industrial Companies follows for 1980:

	ASSETS (000,000)	EARNINGS (000,000)	EMPLOYEES (000)
AMERICAN TEL. & TEL.	$125,451	$6,080	1,050
*WESTERN ELECTRIC	8,048	693	177
MANUFACTURING			
GENERAL MOTORS	34,581	(763)	746
IBM	26,703	3,562	341
FORD	24,348	(1,543)	427
GENERAL ELECTRIC	18,511	1,514	402
PETROLEUM			
EXXON	56,577	5,650	177
MOBIL	32,705	3,272	213
TEXACO	26,430	2,643	67
STANDARD OF CALIF.	22,162	2,401	40
STANDARD OF IND.	20,167	1,915	56
GULF	18,638	1,407	59

*Western Electric ranks ninth in sales among U.S. manufacturing companies - Data for Western Electric also included in AT&T total.

We would not suggest that size alone would necessarily raise anti-competitive or other monopoly problems. But, the Bell System's unique size and local service monopoly plus its market share and its use of anti-competitive practices together certainly do. Mr. Theodore F. Brophy, Chairman and Chief Executive Officer, General Telephone and Electronics Corporation, in his thoughtful statement before the Senate Commerce Committee on June 16, 1981 raised the market share problem in the following terms (p. 17):

> "We cannot overemphasize the difficulty of this proposition because of the market share enjoyed by AT&T. AT&T serves more than 80 percent of all the telephones in the U.S. and accounts for nearly 85 percent of the total telephone industry operating revenues. Such a large percentage of market share residing in one entity requires special safeguards if competitors are to have an opportunity to survive. The magnitude of this market share can best be appreciated when compared to the 18 percent share of the petroleum industry market enjoyed by Exxon and the 23 percent of the domestic steel industry controlled by U.S. Steel."

Mr. Brophy also referred (p. 18) to a study appearing in the Harvard Business Review, January-February, 1975, which referred to the unique advantages of large market share which appeared to occur "at market shares greater than 40 percent."

A market share double the critical 40% level obviously increases the opportunities for anti-competitive pricing and cross-subsidization.

Anti-competitive pricing

Although the Bell System usually has to submit studies and undergo delays in receiving general rate increases, it frequently has been able to put into effect anti-competitive prices for individual services and leave them in effect even after they have later been declared unlawful.

State public service commissions for the past several years have been faced with the Bell migration policy on PABX's. Under this policy Bell apparently has arbitrarily increased the tariff rates on old PABXs and has priced new PABX's at what it alleges are "competitive" prices.

A number of large states have forced Bell to raise its Dimension PABX prices by 40 to 70% to avoid cross-subsidy by captive rate payers. Moreover, Dimension pricing has formed part of the basis for at least two of the recently decided antitrust suits against the Bell System. In a case filed by Northeastern Telephone Co., a small supplier of telephone equipment, the U.S. Court of Appeals, Second Circuit reversed that portion of a jury award which had found the Bell System guilty of predatory pricing (more recently a district court in the Litton case has applied the new rule) on Dimension PABX's. The court held, in effect, that any price above average variable cost was immune to antitrust attack whether or not defendant had subsidized the price with rates charged to rate payers on non-competitive service. Although the Court held that the defendants were clearly subject to the antitrust laws, it nevertheless decided that any relief from cross-subsidization would have to come from the Public Utility Commission. The Court stated that if, as Northeastern apparently believed, "the DPUC is either asleep orincompetent" or "is unable to perform these studies, its recourse is to intervene before that body and, if unsuccessful, to appeal to the State Courts."

The inability of the FCC to prevent anti-competitive pricing has been spelled out in a number of FCC documents and in the testimony of those who have dealt with the problem from the regulatory side.

Mr. Walter Hinchman, former Chief of the Common Carrier Bureau and now a consultant, testified on May 20, 1981 before the House Subcommittee on Telecommunications, Consumer Protection, and Finance. He presented a Briefing Paper on "The Evolution of Common Carrier Regulation" from which the two final paragraphs are quoted:

> "During the past 2 or 3 years, the Commission seems largely to have abandoned its efforts to establish effective, auditable cost determination procedures or otherwise to regulate the

> cost/price relationships in carrier tariffs. There has been no further Commission action concerning a new uniform system of accounts and related records, which was once a top priority objective, in more than a year. Without formal notice or action, the Commission also appears to have abandoned many of the cost determination and ratemaking principles adopted in Docket 18128, in the course of ruling on individual tariff issues.
>
> As a substitute for these difficult and complex regulatory processes, the Commission is now placing increased if not exclusive reliance on so-called 'structural' and 'market force' solutions, such as the required creation of separate subsidiaries and increased emphasis on 'resale' opportunities as the sole mechanisms for precluding monopolistic, cross-subsidized pricing. The potential effectiveness of these measures in controlling the various types of monopoly pricing and cross-subsidized, anti-competitive pricing and practices that have been encountered in the common carrier business is another area of considerable debate. My view is that in the absence of effective, auditable cost determination procedures and an active, determined audit capability within the FCC, these new 'solutions' will be equally if not more ineffective in preventing such pricing and other practices, and that the ultimate public interest objectives of common carrier rate regulation are thus further from realization today than they were at the conclusion of Docket 18128 in 1976." (Underscoring supplied).

Edward Goldstein, Assistant Financial Officer of AT&T, in a prepared statement presented to the House Committee on Interstate and Foreign Commerce, on May 8, 1979 said:

> "So, what's the problem?
>
> What we do not have is a good cost accounting system as opposed to a financial accounting system -- that will allow us to determine accurately and routinely, on an ongoing basis, the cost of the individual services we provide our customers." (Emphasis in original)

A somewhat different assessment of the problem was given by Dr. William Melody, a former staff member of, and later a consultant to the Federal Communications Commission, and now on the faculty of Simon Fraser University in Vancouver, British Columbia. In testifying as a Justice Department witness, Dr. Melody was quoted, in part, in the

June 15, 1981 issue of Telecommunication Reports (at pages 13-14) as follows:

> "Dr. Melody said that a dominant monopolist must reassess its position when competition enters the market. In lowering its price, a dominant firm should examine whether it is covering its costs. AT&T, by lowering competitive service prices, still made a shareholder profit by its higher monopoly service charges, he stated.
>
> He declared that AT&T has established competitive prices without regard to cost . . .Cost studies have contained egregious deficiencies, and were unreliable, with the sole intent to meet the regulatory agency's request for information. AT&T engaged in a pricing policy to exclude competition.
>
> Dr. Melody said that the FCC has recognized for 20 years the possibiltiy of cross-subsidy of services by AT&T, and it has now given up on the task. It has reached the conclusion that AT&T competitive price cuts are not related to costs, the cuts are unlawful, but the FCC is not able to do anything about it. The FCC has recently failed in its efforts to get cost and price information, relating to various services, and the FCC is not even attempting to get such information anymore." (Underscoring supplied)

FCC Administrative Law Judge Walter C. Miller's Initial Decision in Phase I of Docket No. 20814 issued March 12, 1979 deals with the history of the FCC's failure to regulate AT&T's tariffs, and the Commission's frustration as illustrated by a statement by Commissioner Washburn (page 7, footnote 11):

> "In today's action we have found the last four WATS Tariffs filed by AT&T to be unlawful. Some of these Tariffs have been in effect for over three years. Further we allow these unlawful rates to remain in effect for at least another six months after the decision is published in the Federal Register. ... After the public has been paying these rates for four years we have no way of assuring that the new tariffs will be any better or worse than the present unlawful tariffs they will replace.
>
> The result is a series of Bell tariffs, all of which the Commission finds unlawful but which customers must pay. Refunds cannot be made, despite the accounting order, because we have no legal tariff with which to compare and compute any overcharges. The Commission,

> therefore, has essentially lost control over the rates Bell charges customers ... The 'significant costs of regulatory delay' take the form of virtually unregulated rates for a major service. These costs are visited not upon the carrier but upon the public..." (Underscoring supplied).

After pointing out the vital role of the historical background in this MPL tariff case, Judge Miller (at pages 13-14), continued with:

> "In the WATS decision, Commissioner Washburn ...concluded that the Commission has lost control over the rates Bell charges its customers. Actually he was understating the problem. You cannot lose what you have never had. A careful reading of the historical background shows that the Commission has never had any control over Bell's rates." (Underscoring supplied).

Cross-Subsidization

In addition to pricing of competitive services to prevent competition, the Bell System has, because of its market dominance and vertical integration, many ways in which to use ratepayer money to cross-subsidize activities which have potential or actual competition.

As discussed earlier, AT&T has effectively prevented any competition to Western Electric's sales to the Bell operating companies. It has thereby stifled the growth of Western Electric's potential manufacturing competitors (in many cases below a level necessary to sustain a competitive operation).

Western Electric has been able to maintain defense and other non-Bell business with sales well in excess of a billion dollars a year. Neither the regulatory agencies nor anyone else can be certain as to whether this business is priced on an "average variable cost basis", or is produced at an overall profit or a loss.

In any event, AT&T, since it controls both the market and the prices for the Bell System without challenge, can price its non-Bell business as low as it wants. S. 898 confirms Western Electric's monopoly in the Bell market and sustains the status quo.

I will not try to spell out here all of the advantages accorded Western Electric by Bell management in its effort to maintain vertical integration, except to point out: (a) Western Electric pays no license fee for Headquarters' assistance in management, financing, personnel, etc. (local Bell operating companies pay more than $700 million per year for these services); (b) Western Electric pays only that portion of Bell Labs' billion dollar research and development expenditures which AT&T management decides to allocate to it. The Bell operating companies pay the balance, despite the fact that Western Electric has access to all research and development, and its potential competitors do not.

AT&T Headquarters collects more than a billion dollars per year (estimated as high as $1.3 billion currently) under license contract agreements with the Bell operating companies and Long Lines. The rates charged to the operating companies vary from as low as 1 percent of revenues in some states to as high as 2 1/2 percent in other states, apparently, for the same service. Moreover, Long Lines, which is a division of AT&T and not regulated by any state, paid 5.79 percent of revenues in 1979, the last year for which information is available.

License fees collected in recent years have increased at a phenomenal rate. For example, the fees collected in 1979 (1980 data is not yet available) increased by some $233 million over those collected in 1978. The increase for 1979 alone exceeded the total collections just nine years earlier in 1970. The fees collected from Long Lines in 1979 were 39 percent higher than those collected in 1978.

The FCC has not up to now attempted to regulate or police this huge fund collected from the ratepayers and apparently has no information on the reasons for the large increases in recent years and, in particular, for those during 1979. Only one state (California) has attempted a real study of AT&T's charges to the Bell operating companies. California disallowed a substantial portion of the expenses for one year as not appropriate for payment by the local Bell operating company; other states have simply arbitrarily limited payments to one percent of revenues with the result that some ratepayers are paying 2 1/2 times as large an assessment as others.

After many requests from state public utility commissions, the FCC has finally filed a notice of inquiry on the license fee payments. This study will, no doubt, take years to complete, and decisions, if any, will be based on AT&T special cost studies, not audited accounting records reflecting costs by services. In the meantime, it is reasonable to assume that the recent huge increases in fees paid by the ratepayers are being used to subsidize competitive activities presumably in anticipation of the unregulated "fully separated affiliate."

In this connection, the FCC Notice of Inquiry comments that "a substantial increase in the Bell System's basic research coincided with a general advent of competition." but offered no explanation of this or the increases in Headquarters' expenses, including marketing. According to AT&T, basic research has nothing to do with product research and development paid for directly by Western Electric.

It is not at all clear to what extent the hundreds of millions of dollars of marketing and development costs already spent or now being spent and charged to the ratepayers for development of "Advanced Communications Service," for example.

will be returned to the ratepayers and charged to the newly organized and unregulated FSA.

FCC Regulation and the "Fully Separated Affiliate"

The authors of S. 898 have recognized that a vertically integrated corporation with over 100 billion dollars in assets and one million employees spread across the contiguous 48 states, with more than 80% of the telecommunications operations in those states, is dominant.

Having recognized this, S. 898 first beefs up AT&T's competitive posture, opens new markets to AT&T, closes an important market to AT&T's competitors and then proposes to protect the public with more FCC regulation and a "fully separated affilate". Anyone, whether customer or competitor, who relies on this proposed legislation for protection will find he has swallowed two myths. The two are:

a) The myth that AT&T is regulatable and that the FCC is both able and willing to deal with anti-competitive actions by AT&T or any other company for that matter.

b) The myth that the "fully separated affiliate" is something more than a fully integrated division of AT&T with a separate set of books like any other division and managed like any other division.

It is an understatement to say that the Federal Communications Commission has been unable to regulate anti-competitive practices, particularly those involving AT&T. Four major issues involving attempts by the AT&T to prevent the sale of non-Western Electric equipment both to the Bell System and its customers will give some indication of the magnitude of the problem:

1. In 1959, the FCC for the first time authorized the use of industrial microwave systems. These involved the development of communications systems using non-Western Electric equipment and they divert long-distance

revenues from the Bell System. AT&T met this challenge by establishing volume discount tariffs known as Telpak and WATS. These tariffs, which were involved in long years of litigation before the FCC, were all ultimately held to be unlawful, but they nevertheless remained in effect for some 20 years.

2. The clear right of customers to attach their own terminal equipment procured from non-Western Electric manufacturers was fought by AT&T for 12 years before the FCC and through the Courts. The fight ended in 1977 before AT&T had to acknowledge that there was no technical reason why the equipment should not be connected.

3. Competitors of AT&T have attempted since 1969 to gain interconnection to the Bell System at reasonable rates. The resulting legal battles which were waged before both the FCC and the Courts have clearly established the right to physical interconnection. However, the carriers have been forced to accept inadequate local interconnect arrangements which have been arbitrarily determined by AT&T. This problem remains unresolved by the FCC.

4. The Bell System has effectively foreclosed its multi-billion-dollar equipment market to other than Western Electric suppliers. The FCC has now been dealing with this problem for sixteen years. Finally, four years ago the FCC issued an order which did not adequately deal with the problem, but nevertheless would have required the Bell operating companies to deal with Western Electric at arm's-length. The FCC has been considering AT&T's refusal to comply with this requirement for the last four years.

Fully Separated Affiliate

S.898 (Section 227) attempts to deal with the anti-competitive problems posed by the establishment of a 100 percent owned and unregulated AT&T subsidiary labeled "fully separated affiliate." The Bill would establish the FSA's independence by having it maintain separate books and records (though not cost records); would give it an outside board of directors; require separate officers and employees; would require the transactions between the regulated affiliates and the FSA be fully auditable and compensatory; and, finally, would ban joint ownership of property (except in the case of international telecommunications facilities).

Having established the facade of separation and independence in Section 227, S.898 proceeds to cut through this pretense in Section 202(d) by providing as follows:

> "(d) Except as provided in sections 227 and 228, nothing in this Act is intended to preclude management personnel of a dominant-regulated carrier from directing the operations of any dominant-regulated carrier, any affiliate and any fully separated affiliate, except that costs of such direction shall be properly allocated to any dominant-regulated carrier, its affiliates or fully separated affiliate." (Underscoring supplied).

Since nothing in Sections 227 or 228 prevent the management of AT&T, as the sole stockholder of the FSA, from firing the 50 percent outside board on any day it wishes, it is clear that there is no limitation on AT&T's ability to run the FSA as it would any other subsidiary or division. And, although the prohibition against joint ownership of property might, on its face, appear limiting, it, in fact, is not. Unlike its competitors who must, in the process of establishing business, live with excess facilities, the FSA is under no such restraint. It can either build its own transmission facilities or buy the transmission facilities from Long Lines or Bell operating companies and immediately lease back at a 13 percent after tax return the excess facilities it has acquired.

In other words, the same official in AT&T who manages the FSA may also manage Long Lines, and he can then decide who puts in which facilities and who leases the excess from the other at what price.

Options for a Competitive Industry Structure

S. 898, as finally revised on July 16, 1981 by the Senate Commerce Committee, is so slanted toward the promotion of the Bell System that it would appear well nigh impossible to use it as a basis for legislation designed to promote competition and ultimately accomplish deregulation. Rather we think there are a number of options which the Telecommunications Task Force should consider. Among them are these:

a) The separation of unregulated activities into a separate company or companies which would then be spun off to AT&T stockholders. We have never made this recommendation but anyone who understands this industry and looks objectively at the options for maximizing deregulation and competition would have to place this option at the top of the list.

b) If the telecommunications task force decides that the legislative realities require an AT&T partly regulated and partly unregulated, the damage to competition and deregulation now inherent in S. 898 could be minimized by adoption of a number of the detailed recommendations contained in the testimony of Mr. Brophy, Chairman of GTE, (referred to earlier) dealing with AT&T structure (Pages 16-42). Among the more important of these with which we agree are:

   1. Clear separation between services offered by Bell regulated companies and the FSA should be required. The FSA should be prohibited from offering functionally equivalent services or "basic" services on a resale basis.

   2. The affiliate should be prohibited from owning its own transmission facilities or entering into joint ventures with Bell regulated companies.

   3. The FSA should be permitted to offer only new customer premises equipment, as do its competitors, and AT&T should not be permitted to transfer its $10 billion base acquired under monopoly conditions to the new FSA.

   4. Western Electric manufacturing together with Bell Laboratories research and development for unregulated equipment should be transferred promptly. If the FSA were barred by statute from buying products from an affiliate, no doubt the Bell System could accomplish in weeks or months what S. 898 gives it years to do.

   5. The Bell System should be required to procure telecommunications equipment on its merits and until this practice becomes embedded in the System, it should obtain minimum specified volumes of equipment from non-AT&T manufacturers.

c) If the Bell system structure cannot be tampered with, then consideration should be given to leaving Bell fully regulated with the requirement that Bell price its services on a fully distributed cost basis.

Let there be no misunderstanding, in order to maintain the Bell System in its present structure and increase competition in the industry, the FCC will have to be funded and staffed at a level which would permit it to handle anti-competitive actions which arise on a reasonable time basis. Up to this point, as has been shown above, it has been unable to take either effective or timely action.

> If Bell really believes its assertions as to the efficacy of Bell Labs and the efficiency of Western Electric, these advantages, together with the demonstrated ability to raise low cost money and the head start of a long term monopoly in 80% of the market built under Government license, should assure Bell's ability to compete. (If Bell really needs to use variable cost pricing in order to beat back Japanese competition, then it surely will be able to eliminate any American competition at its leisure.)

I realize this is a long letter but I feel a more complete exposition of our ideas than was possible during our discussion is necessary so that you may understand the importance ITT attaches to promoting effective competition in the telecommunications industry. I am also taking the liberty of sending copies of this letter to others who are vitally interested in the future of telecommunications.

Thank you for your consideration. I would be pleased to discuss this subject further with you at your convenience.

Yours truly,

PREPARED STATEMENT OF THOMAS L. THOMPSON

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, MY NAME IS TOM THOMPSON. I AM SPECIAL ASSISTANT TO THE PRESIDENT OF GENERAL DATACOMM INDUSTRIES, OF DANBURY, CONNECTICUT. I AM ALSO A DIRECTOR OF THE INDEPENDENT DATA COMMUNICATIONS MANUFACTURERS ASSOCIATION, INC. (IDCMA), ON WHOSE BEHALF I AM APPEARING TODAY. IN THE INTEREST OF TIME, I WILL DEPART FROM MY WRITTEN TESTIMONY, BUT I ASK THAT YOU INCLUDE IT IN THE RECORD OF THESE HEARINGS.

WHEN I TESTIFIED BEFORE THIS COMMITTEE IN JUNE, I EMPHASIZED THE UNIQUE CHARACTER OF THE TELECOMMUNICATIONS

INDUSTRY. THE OBVIOUS DISTINGUISHING FACTOR IS THE OVERWHELMING DOMINANCE OF AT&T, WHICH CONTROLS THE TRANSMISSION NETWORK ON WHICH EVERYONE MUST DEPEND. THIS DOMINANCE, WHICH WAS GAINED THROUGH GOVERNMENT FRANCHISES, PROVIDES AT&T WITH TREMENDOUS ADVANTAGES IN THE MANUFACTURING AND MARKETING OF CUSTOMER-PREMISES EQUIPMENT. I DISCUSSED THREE TYPES OF CONDUCT THAT THREATEN COMPETITION IN VARIOUS SECTORS OF THE TELECOMMUNICATIONS INDUSTRY.

ONE OF THESE WAS CROSS-SUBSIDY -- THE MISALLOCATION OF COSTS IN A MANNER THAT IMPROPERLY BURDENS TELEPHONE SUBSCRIBERS AND UNFAIRLY ADVANTAGES AT&T'S COMPETITIVE OFFERINGS SUCH AS TERMINAL EQUIPMENT. I UNDERSTAND THAT THE COMMITTEE HAS HEARD A LOT ABOUT THIS TYPE OF PROBLEM IN THE PAST SEVERAL DAYS OF HEARINGS.

THE SECOND PROBLEM INVOLVES DISCRIMINATORY INFORMATION FLOWS. AT&T'S CONTROL OF THE NETWORK GIVES IT IMPORTANT INFORMATION, BOTH ABOUT THE TECHNICAL CHARACTERISTICS OF THE NETWORK AND ABOUT THE INDIVIDUALS AND BUSINESSES WHICH USE THAT NETWORK. TO THE EXTENT THAT ANY OF THIS INFORMATION IS AVAILABLE TO THOSE PORTIONS OF AT&T INVOLVED IN COMPETITIVE ACTIVITIES, IT IS ESSENTIAL THAT THE SAME INFORMATION BE PROVIDED AT THE SAME TIME AND ON THE SAME BASIS TO NON-AFFILIATED MANUFACTURERS, WHOSE EQUIPMENT MUST BE COMPATIBLE WITH THE NETWORK.

THIRD, I DISCUSSED TYING AND TYING EFFECTS, WHICH INVOLVE ACTIVITIES THAT ENCOURAGE THE PERCEPTION THAT THE AVAILABILITY AND QUALITY OF BASIC TELECOMMUNICATIONS SERVICE MAY VARY DEPENDING ON WHETHER THE USER ALSO SUBSCRIBES TO AT&T'S COMPETITIVE OFFERINGS, LIKE TERMINAL EQUIPMENT. SUCH ACTIVITIES CAN INDUCE CUSTOMERS TO SELECT EQUIPMENT SUPPLIED BY AN AT&T-AFFILIATE RATHER THAN AN INDEPENDENT MANUFACTURER.

Each of these types of conduct impairs and distorts the operation of market forces. Together, these practices can destroy the competition that has brought so many benefits to individual and business consumers.

The present regulatory regime is by no means perfect, but it does provide some check on these abuses. My purpose today is to alert you to our concern over proposals to deregulate substantial segments of AT&T's activities and to substitute for regulation a scheme of structural separation. In our view, the only "structural" plan that will eliminate abuses, promote competition, and lessen the need for regulation in the terminal equipment market is the _divestiture_ of those portions of Western Electric and Bell Labs that develop and manufacture terminal equipment.

Structural separation short of divestiture does not purport to alter AT&T's _incentives_ to abuse its monopoly position. In our view, S. 898 will not even curb the _opportunities_ to follow through on those incentives.

The pivotal feature of S. 898 is the "fully separated affiliate," or FSA. Despite the nomenclature, however, AT&T's unregulated affiliate will _not_ be "fully separated" from AT&T's regulated operations. In fact, as the Committee has heard from virtually every witness in these hearings, the separation provisions of the bill are riddled with unnecessary exceptions.

IDCMA's members are most concerned by the need for full separation of _research_ and _manufacturing_ activities. The proponents of S. 898 claim the bill requires the FSA to perform its own research and manufacturing, but the facts are quite different. The bill contemplates a lengthy

TRANSITION PERIOD DURING WHICH UNSEPARATED ELEMENTS OF AT&T MAY PERFORM A WIDE VARIETY OF ACTIVITIES FOR THE FSA, AND THEN IT FASHIONS PERMANENT EXCEPTIONS OF MAJOR SIGNIFICANCE.

THE SIX YEAR TRANSITION IS CLEARLY LONGER THAN NECESSARY. IT FAILS TO TAKE ACCOUNT OF THE FACT THAT PRODUCT DEVELOPMENT CYCLES IN OUR HIGH-TECHNOLOGY INDUSTRY MAY BE ONLY TWO OR THREE YEARS. IT ALSO FAILS TO RECOGNIZE THE RELATIVE EASE OF IMPLEMENTING SEPARATION REQUIREMENTS FOR CERTAIN PRODUCT LINES, SUCH AS DATA COMMUNICATIONS EQUIPMENT. AND IT CERTAINLY MAKES NO SENSE TO GRANT DEREGULATION IN TWO YEARS, WHEN THE TRANSITION PERIOD IS SIX YEARS. IF SEPARATION IS TO REPLACE REGULATION, THEN IT MUST BE IN PLACE AND TESTED BEFORE DEREGULATION.

MORE TROUBLESOME STILL IS THE FACT THAT THE FSA NEED NEVER BE FULLY SEPARATED FOR RESEARCH AND MANUFACTURING. IT CAN DRAW FOREVER ON UNSEPARATED PARTS OF BELL LABS AND WESTERN ELECTRIC FOR DEVELOPMENT AND MANUFACTURING OF COMPONENTS AND SUBASSEMBLIES. COMPONENTS AND SUBASSEMBLIES SOUND INNOCUOUS ENOUGH, BUT IN FACT THEY INCLUDE ALL OF THE PARTS OF AN ITEM OF EQUIPMENT, INCLUDING ALL OF THE "INTELLIGENCE" OF THE DEVICE. TO AN EVER-INCREASING EXTENT, THE COMPONENT IS THE PRODUCT.

THE SECTIONS OF THE BILL THAT DEAL WITH THIS ISUSE ARE RELATIVELY COMPLICATED, AND I RECOGNIZE THAT THE MEMBERS OF THIS COMMITTEE DO NOT HAVE THE TIME TO FOCUS ON ALL THE VARIOUS CHARACTERISTICS OF SUBASSEMBLIES AND COMPONENTS. WHAT SHOULD TROUBLE THIS COMMITTEE IS THE FACT THAT THE SEPARATION ACTUALLY PRESCRIBED IS SO MUCH LESS COMPLETE THAN IT IS CLAIMED TO BE. AS COMPANIES THAT DEVELOP AND MANUFACTURE CUSTOMER-PREMISES EQUIPMENT, AND WHO INVEST SUBSTANTIAL EFFORT INTO THE DEVELOPMENT OF "COMPONENTS", IDCMA'S MEMBERS ARE GRAVELY CONCERNED BY THE LOOPHOLES IN THE REQUIREMENTS FOR STRUCTURAL SEPARATION OF MANUFACTURING AND ASSOCIATED R&D. IDCMA'S MEMBERS CAN AND DO DEVELOP THEIR OWN COMPONENTS; SO SHOULD THE FSA.

WE ARE EQUALLY TROUBLED BY ANOTHER INCONSISTENCY BETWEEN THE CONCEPT OF "FULL SEPARATION" AND THE ACTUAL PROVISIONS OF S. 898. INCREDIBLY, THE BILL EXPRESSLY AUTHORIZES JOINT VENTURES AND PARTNERSHIPS BETWEEN AT&T AND THE "FULLY SEPARATED AFFILIATE." THIS OPEN-ENDED PROVISION SEEMS TO ENCOURAGE THE CIRCUMVENTION OF THE SEPARATION RULES, AND WILL MOST CERTAINLY ASSURE THE CONTINUATION OF CROSS-SUBSIDIES, DISCRIMINATORY INFORMATION FLOWS, AND TYING EFFECTS. EVERY WITNESS WHO ADDRESSED THIS ISSUE BEFORE THE COMMERCE COMMITTEE CRITICIZED THE CARTE BLANCHE FOR UNSEPARATED OPERATIONS. WE ARE CONFIDENT THAT YOU WILL RECOGNIZE THE NEED TO ELIMINATE IT.

I WISH I HAD TIME TO DISCUSS THE BILL'S OTHER SIGNIFICANT FLAWS IN THE SEPARATION SCHEME, SUCH AS JOINT ADVERTISING, JOINT USE OF PROPERTY, COMMON FINANCING, AND TRANSFERS OF EMPLOYEES BACK AND FORTH ACROSS THE SEPARATION LINE. THESE MANY EXCEPTIONS TO THE SEPARATION RULES SHOW CONCLUSIVELY THAT S. 898 DOES NOT PROVIDE THE "FULL SEPARATION" THAT ITS PROPONENTS CLAIM, PARTICULARLY AS PERTAINS TO AT&T'S AND WESTERN ELECTRIC'S CPE MANUFACTURING ACTIVITIES. THE LACK OF ADEQUATE SEPARATION WILL, CONTRARY TO THE STATED GOALS OF S. 898, JEOPARDIZE COMPETITION AND INCREASE THE NEED FOR REGULATION. I ALSO FIND IT CURIOUS THAT, THOUGH THE BILL'S STATED GOAL IS TO INCREASE COMPETITION, IT PRESCRIBES NO SOLUTION TO THE PROBLEM OF AT&T'S RESTRICTIVE PROCUREMENT PRACTICES.

IF I CAN LEAVE WITH YOU JUST ONE ADDITIONAL THOUGHT, IT IS THIS. THE COMMERCE COMMITTEE HAS AGREED TO

PROTECT NEWSPAPERS, CABLE TV OPERATORS, AND THE ALARM INDUSTRY AGAINST COMPETITION FROM AT&T. IF THE FSA WERE TRULY "FULLY SEPARATED," SUCH SPECIAL PROTECTION WOULD NOT HAVE BEEN NECESSARY. WE ARE NOT SEEKING SIMILAR PROTECTION FOR OUR PARTICULAR SEGMENT OF THE MARKET. WE ARE URGING THIS COMMITTEE TO FORMULATE AMENDMENTS THAT ASSURE FAIR COMPETITION IN ALL TELECOMMUNICATIONS MARKETS.

SUPPLEMENTAL STATEMENT OF THOMAS L. THOMPSON

The Independent Data Communications Manufacturers Association, Inc. (IDCMA) is a national trade association comprised of manufacturers of customer-premises equipment used in computer communications. [1] IDCMA's members operate in one of the most competitive sectors of the telecommunications industry. The Association's members are vigorous competitors of each other, and of AT&T's affiliated equipment manufacturer, Western Electric.

IDCMA's members have fought hard for the right to compete. AT&T has placed numerous obstacles in their path, but regulatory and judicial decisions have established a clear preference for competition over monopoly. AT&T is now pressuring Congress to rewrite the rules, and IDCMA's members are concerned that the result will be to adversely affect the competitive environment. The Association commends this Committee for recognizing its proper role in scrutinizing legislation drawn to the specifications of the world's largest monopoly.

I. The Need for A Manufacturers' Perspective.

The "telecommunications industry" is really an assortment of industries which offer a wide variety of services and products that include, or use, or permit the use of transmission facilities. There are obvious differences between a company that provides local exchange service and one that owns and operates satellites, between one that manufactures customer-premises (terminal) equipment and one that offers data processing services, between one that offers alarm services and one that provides telephone answering services. AT&T is now in some of these businesses and is precluded from entering some of the others.

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[1] The members of IDCMA are Codex Coporation, Mansfield, Massachusetts; ComData Corporation, Skokie, Illinois; General DataComm Industries, Inc., Danbury, Connecticut; Infotron Systems Corporation, Cherry Hill, New Jersey; Intertel, Inc., Andover, Massachusetts; Racal-Milgo, Inc., Miami, Florida; Racal-Vadic Corporation, Sunnyvale, California; and Universal Data Systems, Huntsville, Alabama.

Each of these market sectors has its own unique characteristics. Nonetheless, AT&T's overwhelming control of the Nation's telephone network gives it extraordinary power to affect the degree of competition in all telecommunications markets in which it participates. It should be kept in mind that, today, competition is very much on the increase and consumers are reaping the benefits. There is no "crisis" that requires legislative action.

Up to now, the telecommunications policy debate has focused extensively on such issues as the appropriate role for AT&T in competition with newspapers, even though AT&T has thus far taken ony a few tentative steps in this direction. Meanwhile, little attention has been given to the problems of competition in the customer-premises equipment (CPE) industry, despite the fact that AT&T overwhelmingly dominates this market. Western Electric, standing alone, is among the 20 largest companies in the United States. Its conduct in this market directly and immediately affects most American business and individuals. IDCMA believes it essential that manufacturing issues be given greater prominence in the policy debate.

Less than 15 years ago, there was little domestic competition in the CPE market; AT&T, through the Bell Operating Companies and Western Electric, effectively insured that customers used equipment manufactured by Western Electric. Today, in the wake of a series of hard-fought regulatory and judicial battles, competition is robust, and dozens of companies are vigorously vying for a share of the market. This situation leads some to believe that the CPE markets have become fully competitive and ripe for deregulation. It is this premise that underlies S. 898, the Telecommunications Competition and Deregulation Act.

What has been missing from the analysis is a consideration of the differences between market share and market power. Even in those few market sectors where AT&T no longer has an overwhelming lead in market share, it still possesses unique forms of monopoly-derived market power that create significant anticompetitive advantages for the CPE manufactured by Western Electric. The current regulatory regime provides some check against abuses of AT&T's market power, primarily through tariff review of rates and pricing policies and through interconnection requirements that permit customers to use CPE made by independent (non-Bell) manufacturers. In the face of proposals to abandon the current regulatory scheme, it thus is imperative to examine the types of monopoly-based advantages enjoyed by AT&T and to ascertain whether the proposed legislation is likely to increase or lessen competition. In IDCMA's view, S. 898 is fundamentally defective and requires major amendments. [2]

II. Types of Anticompetitive Conduct.

Before discussing the specific provisions of S. 898 in any detail, it may be useful to briefly summarize the types of anticompetitive conduct in which AT&T can engage. These fall into four main categories.

A. Cross-Subsidies.

The one abuse which is most widely recognized is finan-

2/ The comments herein are based on Staff Draft No. 3 of S. 898 and comments made during the Commerce Committee markup. The final Commerce Committee version of the bill has been the subject of numerous "technical and conforming amendments" and is not available as this testimony is prepared.

cial cross-subsidy. It is universally conceded that a monopolist which also enters competitive markets will be motivated to allocate some of the costs of its competitive activities to its monopoly enterprises and therefore to its captive ratepayers. Such misallocations of costs of regulated operations can doubly advantage the carrier. First, the overstated costs assigned to regulated services can all be recouped through an increase in rates for those services; the carrier compensated not only for its costs, but also given a virtually assured rate of return that includes a profit on the inflated expenses. 3/ Second, to the extent that the costs of unregulated activities are understated, the entity can underprice its independent competitors and gain a larger share of the "competitive" market. It is undisputed that AT&T's incentive to do this is unaffected by the creation of a "separate" affiliate to engage in unregulated activities. 4/

B. Information Flows.

A second type of abuse involves discriminatory information flows. Inadequate attention has been paid to the valuable information that AT&T possesses as a result of its control of the transmission network on which everyone must depend. There are two basic categories of such information. The first involves information about the network. The second involves information about users of the network.

The design of customer-premises (terminal) equipment requires a thorough understanding of the technical characteristics of the telephone network. Data communications equipment, which is used in a wide variety of business applications (such as

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3/ Since regulated carriers cannot retain excess returns, their incentive is to use them to subsidize their competitive activities.

4/ "[I]f the parent has an incentive to exercise its market power to the disadvantage of consumers and competitors in the absence of a separate subsidiary, it has the same incentive to do so after one is required." Amendment of Section 64.702 of the Commission's Rules and Regulations (Second Computer Inquiry), Docket No. 20828, Final Decision, 77 F.C.C.2d 384, 462 (1980).

remote access data processing, hotel and airline reservation systems, and police communications networks), is particularly sensitive to changes in the characteristics of the network. Manufacturers of such equipment therefore need to have current information about operational protocols, switching techniques, types of line conditioning, and a variety of other factors which affect throughput and reliability. If one manufacturer has privileged access to such information, it will have a significant advantage over its competitors. [5] Obviously, equal access to information about network characteristics and contemplated changes is essential to assure that independent manufacturers compete on an equal footing.

A word must also be said about the importance of commercial information. Because AT&T controls the telephone network, it possesses a wealth of knowledge about the customers of independent equipment manufacturers. Before a customer may connect a terminal device either to the switched network or to a private line circuit, he is required to advise the telephone company, among other things, as to the nature of the device and the name of its manufacturer. AT&T thus knows, for each subscriber to its services, what terminal equipment that customer uses (whether AT&T or independently manufactured), and effectively what that customer's needs are for specific types of terminal equipment. Obviously, it is a lot easier to market data communications CPE

5/ A recent example underscores the significance of this problem. Currently, and for years past, the great bulk of all switched network traffic has travelled over terrestrial facilities (cables, microwave). In 1978 (or earlier) AT&T decided to make a vastly increased use of satellites for the transmission of switched network traffic. This decision is of tremendous significance to manufacturers of data communications equipment because such equipment is acutely sensitive to minute timing factors. Western Electric was apprised of the plan to route switched network traffic on satellites at an early date, yet independent manufacturers were not given simultaneous access to this information. Independent manufacturers are now hard at work to reengineer their equipment to prevent service difficulties for their customers. Western Electric, having been given advance notice of the network change, has already made the necessary changes to its equipment (in at least one case, as early as 1978).

if you know which users have extensive data communications applications, which users appear to be using equipment that is no longer state-of-the-art, etc.

C. Tying and Tying Effects.

A third category of abuses involves tying and related forms of discrimination. AT&T has encouraged the notion that its products and services are all part of one "system" ("The System Is The Solution") and customers have thereby been induced to select equipment manufactured by Western Electric even when superior equipment is available from independent manufacturers at a lower price. AT&T representatives, with whom the customer must deal to arrange for basic transmission service, can and do suggest that Western Electric equipment is superior to independently manufactured equipment. More importantly, they also have the opportunity to suggest that the availability or quality of basic transmission service may depend to some degree on whether or not the customer selects AT&T-supplied equipment.

D. Market Foreclosures.

A final cateory of abuse involves specific market foreclosures. Because AT&T controls the transmission network, it can foreclose competition by unilateral fiat. A historical example was AT&T's refusal to allow customers to connect independently manufactured devices to the network. A more current example is AT&T's practice of "bundling" transmission offerings with terminal equipment. AT&T can define a terminal device as an "inherent" part of the transmission service offering and insist that the device must be provided by AT&T. At the present time, for example, AT&T is insisting that it alone must provide the Channel Service Unit (or a device that performs the CSU's functions) which is used on the premises of every subscriber to Dataphone Digital Service. As a result, customers are foreclosed from choosing independently manufactured devices for direct connection to DDS, even though independent manufacturers have the proven ability to manufacture devices which perform the functions of the CSU.

Another example of market foreclosure involves AT&T's procurement practices. The Bell Operating Companies and the Long Lines Department purchase huge quantities of telecommunications equipment. Because these purchases are funded by subscribers to monopoly services, AT&T has a duty to weigh price and performance considerations in making its selections. Yet year in and year out, the bulk of the equipment is obtained from Western Electric, regardless of the availability of better or lower-priced equipment from non-affiliated manufacturers.

III. Specific Problems of S. 898.

S. 898 recognizes some of these problems, while ignoring others. The greatest sensitivity is shown to the problem of cross-subsidy; some attention is given to information flow concerns; and no attention at all is given to the tying and market foreclosure problems. Even where S. 898 attempts to deal with a type of anticompetitive abuse, however, the specific provisions of the bill assure that the problem will not be remedied.

The key feature of the legislation is the "fully separated affiliate" or FSA. S. 898 assumes that AT&T's terminal equipment offerings can safely be deregulated so long as the equipment is offered to the public through an entity that is "fully separated" from AT&T's regulated (monopoly) activities. The FSA could not only offer CPE but also own transmission facilities, offer transmission services, and provide data processing services. The problem is that the FSA is by no means "fully separated."

As noted above, the creation of a separate affiliate does not even purport to alter AT&T's incentives to use its control of the Nation's telephone network to gain advantages in deregulated or unregulated markets. Only divestiture of those portions of AT&T that engage in competitive activities can truly affect these incentives. Yet a separate affiliate that is meaningfully separated could do much to curb AT&T's opportunities to follow through on its incentives. Unfortunately, the structure prescribed by S. 898 does not provide adequate assurances against predatory conduct.

A. Lack of Manufacturing Separation.

From IDCMA's perspective, the most troublesome defect in the bill is its failure to require prompt and complete separation of research and manufacturing activities. In fact, key elements of the development and manufacturing process are never required to be separated, and the degree of separation that is required need not be implemented promptly.

Looking first to the length of the transition period, it can be seen that S. 898 currently allows four years before the FSA is required to perform even the final stage in the manufacturing process. Section 228(c)(1),(c)(2). It allows six years before the FSA is required to perform other crucial research and manufacturing functions (as noted below, this requirement is subject to permanent exceptions). Section 228 (c)(3), (c)(4). This timetable is not the product of any demonstrated need for a transition period of any given length. Rather, it reflects AT&T's unsubstantiated assertions as to the difficulties involved in effecting a separation. Such assertions have never been scrutinized critically in view of the relevant factors; AT&T's representations have essentially been taken on faith.

It is important to remember that Western Electric is comprised of two dozen separate manufacturing facilities. Transferring the ownership of the necessary facilities to the FSA could be accomplished in a matter of weeks, and certainly does not require four or six years. No account has been taken of the relative ease of separating certain product lines, such as data communications CPE. Nor has account been taken of the rapidity of product cycles, which may be as short as two or three years in high technology products. It is particularly strange that deregulation is scheduled to occur in two years, yet the structural separation intended to serve as a surrogate for regulation does not have to be implemented for six years. If separation is to replace regulation, then certainly such structural changes must be in place and tested before deregulation.

More troubling still is the fact that structural separation is never required for crucial development and manufacturing activities. S. 898 expressly authorizes the FSA to rely forever on unseparated elements of Bell Laboratories and Western Electric to develop and manufacture "components" and "subassemblies." These are nothing less than all of the parts of an item of equipment! In electronic components, the components contain all the "intelligence" of the device. These provide the greatest opportunities for innovation. Yet the "fully separated" affiliate is free to obtain them from unseparated parts of AT&T forever, so long as they are also marketed to others. 6/

The Committee should keep in mind that, with the advent of large-scale integrated circuitry, the principal functions of most data communications devices will soon be performed by just a few components. Yet the same Western Electric that can supply components and subassemblies to the FSA will also remain involved in manufacturing equipment used in the regulated telephone network. As a result, the permanent exception to the separation requirements will create irresistable opportunities to circumvent the prohibition on cross-subsidies and will also defeat the intent of the information flow safeguards.

6/ The "sale-to-the-world" requirement does not solve the problems covered by allowing permanent non-separation of manufacturing functions. First, the unique design of some components and subassemblies may make them useful to the FSA and to no one else. Second, the FSA will be able to take advantage of a pricing structure that is predecated on the FSA being the only one buying in sufficient volume to warrant major discounts. Third, non-separation will foster public impressions of the FSA as an integrated member of the AT&T family. Fourth, the "sale-to-the-world" provision makes unregulated vendors out of unseparated elements of AT&T, when the very purpose of establishing the FSA was to make it AT&T's only unregulated vendor.

> Recommendation: 7/ The FSA should be required to perform all of its own research and manufacturing within a short time after enactment. Specifically, the lengthy timetable and permanent exceptions of Section 228(c) should be deleted and replaced with a provision that directs the FCC to assure a transition that is as expeditious as possible and in no event longer than three years after enactment.

B. Joint Ventures and Partnerships.

Besides its failure to require full and prompt separation of manufacturing activities, S. 898 contains another provision that greatly impairs the realization of the goals of the separation scheme. Incredibly, the bill specifically authorizes AT&T and the "fully separated" affiliate to engage in joint ventures and partnerships. Section 227(b). Since there is no limitation on the types of activities for which partnerships and joint ventures could be formed, this provision effectively eviscerates the structural separation requirements altogether. It is difficult to conceive of an abuse that S. 898 purports to foreclose that could not be accomplished through joint ventures and partnerships.

> Recommendation: Delete the portion of Section 227(b) that authorizes joint ventures and partnerships and revise the subsection to provide that, to the extent that other provisions of the legislation allow the conduct of business between AT&T and the FSA, such business shall be fully auditable and compensatory. 8/

C. Joint Advertising.

S. 898 expressly authorizes AT&T and the FSA to engage in joint institutional advertising, and it appears to contemplate

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7/ As noted above, divestiture of AT&T's CPE activities is the most appropriate solution to the problems of unfair competition in this market. The recommendations offered on the following pages assume a retention of the less desirable FSA approach.

8/ The portion of Section 227(c) which allows joint ventures and partnerships for AT&T's foreign trade activities, and Section 228(h), which eliminates separation requirements for such activities, should also be deleted. Since the same services and products that are offered abroad will be offered in the United States, non-separation for foreign activities will undermine separation requirements for domestic activities (and disadvantage other U.S. exporters). A truly separated FSA would easily have sufficient resources to compete in foreign markets without drawing on AT&T's domestic monopoly base. Much smaller companies, such as the members of IDCMA, have successfully competed in foreign markets for years.

that the FSA will use the Bell name and logo. Section 227(a)(5), (d)(2). Hundreds of millions of monopoly ratepayer dollars have been spent on promotion of the Bell logo, which is familiar to over 90 percent of the American public. 9/ To allow the FSA to use the AT&T name and the Bell logo will be to assure that the product and service offerings of the FSA trade on the reputation of the company that provides the telephone service on which everyone must depend.

Moreover, the costs of institutional advertising will almost certainly be allocated in a manner that gives an unfair advantage to the FSA. If advertising costs are allocated on a revenue basis, for example, the bulk of the costs will be paid by captive monopoly ratepayers, while the larger share of the benefits will be reaped by the FSA, since the selection of competitive offerings is more likely to be influenced by advertising that is the use of essential facilities).

> Recommendation: Section 227(a)(5) and (d)(2) should be revised to forbid the FSA from using the Bell name and logo and from engaging in joint institutional advertising with AT&T.

D. Information Flows.

As noted above, it is essential that the FSA be given no commercial information or network information that is not similarly available to non-affiliates. S. 898 appropriately forbids the preferential disclosure of commerical information, Section 227(f), but it does not clearly mandate that the FSA and nonaffiliates be given equal access to network information. Section 214(g). While the FCC is given authority to require the filing of reports of network characteristics and plans for changes to the network, the bill permits AT&T to provide such information to the FSA as soon as it is filed with the FCC. Before the information becomes publically available, it is subject to review by the Secretaries of State, Defense, and Commerce, any one of whom can block its release. Section 214(g)(3).

9/ Telephony, at 100 (December 10, 1979).

While national security considerations may make it appropriate to provide for such clearance before information becomes publically available, those same considerations should apply before the information is disclosed to the FSA. Moreover, the bill does not clearly forbid AT&T from providing the information to the FSA in a different form than it is provided to nonaffilaites; the FSA might conceivably be given specific information which is directed to the relevant employee in the FSA, while competitors of the FSA may have to sift through stacks of unprocessed reports to ascertain the necessary information. Policing of information flow safeguards will be difficult under any circumstances, but the problems will be exacerbated by AT&T's plans to rotate employees in and out of the FSA.

> Recommendation: Section 214(g) should be amended to make it clear that disclosures of network information to the FSA (and to unseparated elements of AT&T that perform research and manufacturing for the FSA 10/) must be made only by way of reports to the FCC which become available to the FSA (and the competitive support divisions mentioned above) only at the same time and upon the same terms and conditions as they are made available to others.

E. Ownership of Facilities.

S. 898 authorizes the FSA to own and operate transmission facilities and to offer transmission services which are the equivalent of the services offered by the Bell Operating Companies and the Long Lines Department. This creates the danger that AT&T will focus its resources on constructuring and upgrading the transmission facilities owned by the FSA, while the regulated network is permitted to deteriorate. The Federal Communications Commission considered this problem and concluded that the only solution is to forbid the FSA from owning any transmis-

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10/ This aspect of the problem will arise during the transition phase. If the permanent exceptions to the requirement of manufacturing separation are not removed, the problem will continue indefinitely.

sion facilities. [11] If the FSA is required to obtain the use of transmission facilities from regulated portions of AT&T (pursuant to tariff) or from others, AT&T will have a greater incentive to attend to what must remain its principal responsibility -- maintaining and improving the basic telecommunications network.

> Recommendation: Section 228(g)(2) should be amended to foreclose the FSA from owning transmission facilities and to require that if it obtains the use of such facilities from AT&T, it must do so pursuant to tariffs.

F. Assets Evaluation.

At the outset of the transition process, AT&T will transfer literally billions of dollars worth of terminal equipment and other assets to the FSA. If these assets are undervalued, the competitors of the FSA will be disadvantaged by the FSA's ability to underprice its equipment offerings. Yet S. 898 does not ensure that the assets will be properly valued. Instead, it contemplates the formation of an assets evaluation board comprised of one member of the FCC, one representative of AT&T, and a state public utility commissioner selected by the FCC and AT&T representatives.

It is bizarre that AT&T should be permitted to exercise regulatory authority of this type. Independent expert judgment, not the unencumbered pursuit of corporate self-interest, is essential if the asset evaluation process is to protect the public interest. AT&T can appropriately be permitted to submit its views as to the proper valuation of transferred assets, and interested parties can appropriately be permitted to submit their views as well. But the ultimate valuation must be made by an authority whose sole obligation is to the public.

> Recommendation: Section 228(f)(5) should be amended to make it clear that assets transferred to the FSA are to be valued by the FCC,

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[11] "Inherent in the resale structure is the fact that the separate corporate entity may not construct, own, or operate its own transmission facilities." Amendment of Section 64.702 of the Commission's Rules and Regulations (Second Computer Inquiry), 77 F.C.C.2d 384, 474 (1980).

> with due regard for the interests of monopoly ratepayers and the competitive environment. The FCC should also be given express authority to block the transfer of certain assets. 12/

G. Procurement Policies.

As noted above, the Bell Operating Companies and the Long Lines Department tend to buy Western Electric equipment regardless of the availability of independently manufactured equipment that works better or costs less. This is a major focus of the pending Government antitrust case against AT&T, and the problem has also been recognized by the Federal Communications Commission (which has ordered that the problem be corrected, but without success to date). 13/ It is curious that S. 898 is intended to open new markets to AT&T's entry, yet the largest telecommunications equipment market of all (that of AT&T and the Bell Operating Companies) remains effectively closed to competition. Monopoly ratepayers should not be forced to pay for the purchase of equipment that is not the best available for the money.

> Recommendation: A new section should be added to S. 898 to make it clear that the equipment used to provide AT&T's regulated services must be selected on a competitive bidding basis. The FCC should be given authority to oversee the process to assure that Western Electric equipment is not selected over other equipment because of advantages arising out of affiliation.

H. Interconnection.

The cornerstone of competition in the CPE marketplace has been the requirement of interconnection. After years of battles before the FCC and the courts, independent manufacturers won

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12/ Patents, for example, should not be transferred at all. The Consent Decree requires that AT&T license its patents to nonaffiliates upon the payment of a reasonable royalty, but S. 898 would relieve the FSA of this requirement. Section 229(d)(2). The bill also relieves AT&T (not just the FSA) from any patent licensing obligation with respect to companies having foreign ownership of 20 percent or more. Section 229(a).

13/ AT&T told this Committee last week that it had formed a Bell System Purchased Products Division to encourage competitive procurement, but it failed to note that the Commission has ruled that the response failed to redress the long-standing problems that the Commission had ordered AT&T to remedy (the text of the FCC's order is not yet available).

the right to connect their equipment to common carriers' facilities so long as the equipment meets technical standards that guard against danger to the network. Yet S. 898 will cut back on interconnection requirements by making them applicable only to "regulated services." Section 207(a). The transmission services offered by the FSA will not be regulated services and therefore the bill appears to authorize it to forbid the interconnection of independently manufactured equipment. Users have greatly benefitted from interconnection opportunities because they can select equipment that best suits their needs as to performance and price. S. 898 should be amended to require that all carriers allow CPE interconnection.

> Recommendation: In Section 207(a), delete the word "regulated" so that all carriers must permit interconnection of terminal equipment with their transmission services.

I. Capitalization.

AT&T's relationship with the capital markets is unique. It has almost unlimited access to capital, and it can borrow at a rate lower than virtually anyone else. Because of its utility functions, it also enjoys an effective tax rate that is much lower than most other companies. If the FSA can draw on AT&T's unlimited financial reserves, it will have unearned advantages over its competitors. S. 898 ignores this problem.

S. 898 also permits AT&T to own 100 percent of the FSA's stock. Such total ownership will assure an identity of interest between the parent and the FSA rather than encouraging the development of separate profit centers with independent goals. If some outside ownership were required, the FSA would operate somewhat more independently; although AT&T would retain control, certain reporting requirements and fiduciary duties would increase the independence of the organization.

> Recommendation: S. 898 should be amended to require that the FSA repay AT&T's investment within a specified period and to assure that thereafter the FSA obtains its capital independently. Consolidated tax returns should be

forbidden, and a specified portion of outside ownership should be required.

J. FCC Flexibility

In effect, S. 898 sets in motion an antitrust reorganization of the largest company on Earth. Given AT&T's past anticompetitive behavior, and the risks of permitting this giant utility to undertake deregulated and unregulated activities, the FCC must have authority to oversee the transition and to make necessary adjustments in the separation rules as dictated by evolving experience and changing circumstances. S. 898, however, specifically forecloses the FCC from exercising any direct regulatory authority over the FSA. Section 202(c), 205(b), 228(e). As a result, there is the very substantial danger that the bill will prove to have unintended adverse effects on competition and that congressional intervention will be the only remedy, even though it may be too late.

> Recommendation: Modify Section 202(c), 205(b), and 228(e) to make it clear that the FCC can take such action as may be necessary to block anticompetitive activities or protect monopoly ratepayers.

IV. Conclusion

A variety of problems have been outlined which show some of the anticompetitive practices through which AT&T can undermine the free play of market forces. S. 898 purports to address some of these problems, but it ignores others. Even where S. 898 acknowledges a problem, it leaves or creates opportunities to circumvent the "safeguards." And, as noted at the outset, the incentive to engage in such predation is left fundamentally unaltered by the requirement of a "fully spearated" affiliate. For this reason, IDCMA firmly endorses the conclusion reached by the Justice Department that divestiture of Western Electric and associated elements of Bell Telephone Laboratories is essential.

If Congress is not prepared to order such divestiture, the best course is to leave the question of AT&T's structure to the courts. If Congress is determined to address the issue of

AT&T's structure, and it is not prepared to order divestiture, substantial changes must be made in the structural separation plan. Without such changes, S. 898 would pose a substantial threat to the competition in telecommunications and other electronic equipment that today is bringing such great benefits to businesses and individual consumers.

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